

2002 ANNUAL REPORT



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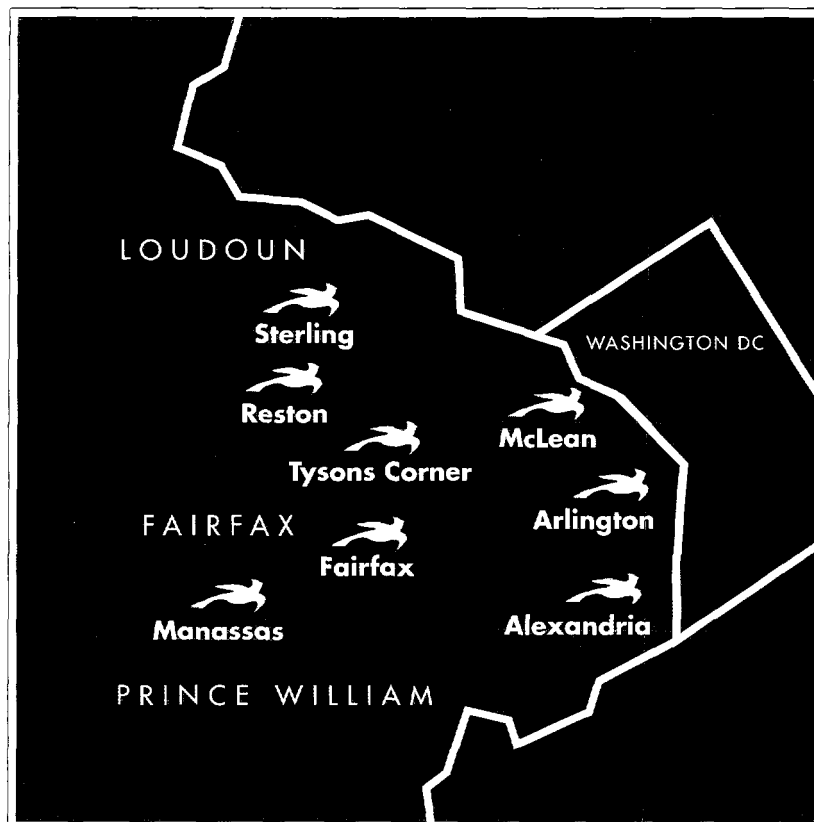
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THOMSON  
FINANCIAL

**CARDINAL**<sup>SM</sup>  
Financial Corporation



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## MESSAGE TO SHAREHOLDERS

We are pleased to report that 2002 was a year of excitement and progress for Cardinal Financial Corporation. We strengthened our capital base, introduced new programs and services, built market share, and completed the consolidation of four separate banking operations. Through these efforts, we have established a new momentum throughout the organization that is helping us build the foundation for Northern Virginia's next premier community bank.

A successful secondary stock offering in the second quarter of the year generated \$18.5 million in new capital, further strengthening the well-capitalized status of Cardinal Bank, N.A. The additional capital also provided greater lending limits, giving us the ability to serve an even broader range of credit needs for new and current customers.

We created a *Government Contract Lending* group to enhance our commercial lending capabilities and real estate lending resources. These initiatives made it possible for Cardinal Bank to serve more businesses in our community and helped our bank post record increases in loans during the fourth quarter of 2002. A major emphasis was placed on Small Business Administration (SBA) products since we can now proudly offer our clients SBA Preferred Lender expertise. We are eager to expand our service to this important business segment.

During 2002, we focused on serving the financial needs of families and individuals by promoting several outstanding retail services, including *Totally Free Checking* and our *President's Club Relationship Plan*. We attained additional success by offering a new *Home Equity Line of Credit* with a very competitive introductory rate that has attracted considerable attention in the markets we serve. As a result of these and other attractive products and services, we have become the bank of choice for more families and individuals, while increasing total deposits by 72 percent and loans by 24 percent during 2002.

In November, we opened our first banking office in Arlington County, expanding our branch network to eight locations. Our long-range strategy is to establish a significant presence for Cardinal Bank throughout Virginia. It is our goal to be the convenient, first choice for more families and businesses by providing the value-added products and the unparalleled personal service that sets Cardinal Bank apart from its competitors.

Through our subsidiary, Cardinal Wealth Services, Inc., we offer our customers more choices with brokerage, investment management and insurance services to meet the broadest possible range of financial needs for families, professionals and executives. Cardinal Wealth Services ended the year with approximately \$100 million in assets

## MESSAGE TO SHAREHOLDERS

under management and is looking forward to a new and exciting association with Raymond James Financial Services in 2003. This diversified financial services company engages primarily in investment and financial planning, including securities brokerage, asset management, cash management and life insurance. Raymond James provides services to more than one million individual and institutional investors throughout the United States and worldwide.

Total assets of Cardinal Financial Corporation were \$486.3 million at year-end 2002, compared to \$279.6 million in 2001. Loan volume ended the year at \$249.1 million, up 24 percent over the previous year, while deposits increased to \$423.5 million, up 72 percent.

For the year, Cardinal Bank recorded a net loss of \$1 million, due primarily to a \$1.7 million impairment of a WorldCom bond in the second quarter. Excluding this one-time loss, your company made .08 cents per common share for the year, which represents profitability in the last three quarters of 2002.

Excellence in banking has always incorporated three ingredients: quality people, superior service, and great value. We have those key elements in place today. Our management team includes some of the most senior banking professionals in the region sharing strong local roots. They are market leaders with customer-driven values that align with the company's core

values. They have in-depth experience, expertise and knowledge of the dynamics and the needs of the communities we serve.

Our investments in technology have assisted our staff in delivering accurate, responsive service to customers. Additionally, our home banking



*Management Team: Bernard Clineburg, Chairman & CEO; Eleanor Schmidt, Executive Vice President; Carl Dodson, Executive Vice President, Chief Operating Officer & Chief Financial Officer; Chris Bergstrom, President; Dennis Griffith, Executive Vice President; Kevin Reynolds, President.*

and bill paying services offer consumers around-the-clock access to their accounts and the ability to pay bills online. On the business side, we offer Internet-based corporate treasury management services for online ACH originations and other services. We have recently upgraded our branch systems with a state-of-the-art relationship

## MESSAGE TO SHAREHOLDERS

management program. We can now retrieve customer information faster and provide more efficient response when our customers need answers and solutions. Our voice and data networks will soon be merged for improved communications capabilities.


In 2002, Cardinal Bank, its officers and employees maintained an active role in community and charitable functions with many organizations. These organizations included the American Heart Association, the Prince William Education Foundation, OWL Volunteer Fire Department, City of Fairfax Renaissance Housing Corporation, Loudoun County Economic Development Commission, and a business partnership with Armstrong Elementary School in Reston—as well as many other community, business, and civic organizations. We are particularly excited about a new liaison with the Inova Kellar Center, a not-for-profit outpatient mental health and substance abuse treatment center serving children, adolescents and their families in Northern Virginia. In May, 2003, we will sponsor the inaugural *Cardinal Bank Charity Golf Classic* to benefit the Center's family programs.

It has been a challenging, but very progressive year. We have achieved some excellent results in spite of a local economy that is still feeling the effects of a downturn in several key sectors. We are confident in the overall strength and resilience of the region, and in our ability to take advantage of the opportunities available in this

diverse and dynamic marketplace. The business strategies we have put into motion this year are aggressive in every aspect except risk. We are very conservative in that regard. Going forward, our goal is to build a strong market niche with a sharp focus on sustained profitability and value for shareholders.

More than ever, there is a role and a need for a locally-based community bank with talent, energy and community commitment. Businesses and consumers deserve a local banking alternative, and our goal is to make the selection of Cardinal Bank not just a viable option, but the *preferred* option. To become Northern Virginia's bank of choice, we must build value for our shareholders, customers and employees. The year 2002 represented a good start for our company. With the dedicated leadership of our directors, the continued hard work of our employees, and the support of our loyal shareholders and customers, we are confident that we can take Cardinal Financial Corporation into what promises to be an exciting, new community-banking era.

Sincerely,



Bernard H. Clineburg  
Chairman of the Board and Chief Executive Officer

## REAL ESTATE LENDING



Dennis Griffith, Executive Vice President

In 2002, Cardinal Bank's Real Estate Lending group focused on healthy sectors of commercial development such as medical and professional offices and not-for-profit facilities that included schools, churches and country clubs. In addition to funding the purchase or refinancing of these commercial properties, this initiative created new opportunities for Cardinal to develop ongoing banking relationships with these organizations and professionals.

In the residential area, consumers who bought a first home, built their dream home, or simply refinanced an existing mortgage also found the Real Estate Lending group to be responsive and supportive, with excellent rates and a variety of mortgage options.

Cardinal Bank's Real Estate Lending group provides comprehensive financial services to builders, developers, real estate investors and individual property owners. Expanded lending limits, a result of the new capital generated by the stock offering, put the group in an even stronger position to participate in real estate opportunities throughout the Northern Virginia region. Dennis Griffith, a seasoned banking professional with more than 30 years of real estate experience, joined Cardinal Bank in April 2002 to lead the group to a new phase of growth.

In 2002, real estate lending grew to \$29 million, up 33 percent over 2001. Contributing to this growth was an emphasis on serving the needs of investors/developers in financing land acquisitions and the cost of developing properties prior to resale to builders.

Another important segment is the financing of owner-occupied buildings for professionals and executives who find that building an office or a headquarters offers advantages over leasing. Although Cardinal Bank is active in the development of residential properties, the emphasis has been on "infill" projects in established, close-in suburbs. The Bank believes that such projects offer ample opportunities for growth while minimizing the risks inherent in financing real estate projects, even in an aggressive market such as Northern Virginia.

The advantage that Cardinal Bank brings to investors, developers and owners is the same element that we provide in our other areas of business: a significant pool of local experience, delivered in a responsive, creative way. As more and more real estate professionals learn about the advantages of working with Cardinal, the Real Estate Lending group can look forward to playing an even larger role in meeting the real estate financing needs of businesses and individuals.

Government contracting has always been an important part of the Washington area's business community and a key part of Cardinal Bank's commercial lending activities. Recognizing the unique borrowing needs of government contractors, Cardinal Bank established Government Contract Lending as a separate group within Commercial Lending in May of 2002.

This specialized group is staffed by experts who have extensive experience working with government contractors, offering services to companies from start-up operations to established government contracting firms. Products and services are focused on providing the financing to help companies manage their cash flow, achieve greater profitability and grow.

Regardless of the size of the loan request, Cardinal Bank offers the expertise, personal service and quick response that only a community bank can provide. Through Cardinal's *Business Manager* program, the Bank purchases a client's government invoices to provide immediate funding for start-up companies or early-phase contract work. For more established firms, the Bank uses its asset-based lending program to finance a contractor's accounts receivable, thereby supporting the company's growth.

The goal of Cardinal Bank is to be the premier bank among small- to medium-sized government contractors, not only in lending, but also in meeting their full range of deposit, cash management, and investment needs, as well as their personal banking needs.

To be even more responsive to customer needs, the Bank has established a Government Contract Advisory Board, consisting of CPAs, attorneys and other visible business leaders. Input and advice from the Advisory Board helps the Bank stay in touch with industry trends and identify new areas of opportunity.

## GOVERNMENT CONTRACT LENDING



Cathy Peterson, Assistant Vice President & Asset Base Lending Administrator and Chris Bergstrom, President

A federal, state or local government contract means new opportunities for growth, but often requires the help of a knowledgeable and responsive financial institution. The mission of Cardinal Bank's Government Contract Lending group is to help clients meet their operating needs between winning the contract and delivering the goods or services to the respective agency.

Cardinal Bank is especially attuned to the needs of small- and mid-sized contractors who may not have the dollar volume required by larger national and regional banks. A major focus is finding innovative ways to solve credit and cash flow needs, as well as providing the very best banking services to this specialized group of clients. The Bank is committed and staffed for continued growth and success in this important area of Government Contract Lending.

## RETAIL BANKING



Pictured at the Arlington Office Ribbon Cutting Event are (left to right): Rich Dowd, Arlington County Chamber President; David Bell, Arlington County Clerk; Catherine Johnson, Cardinal Bank VP & Branch Manager; Stephen Hall, Arlington County Police Chief; Bernard Clineburg, Cardinal Bank Chairman & CEO; and Bill Buck, President of Buck & Associates Realty.

The highlight of the year in Retail Banking was the opening of our Arlington office on North Glebe Road. Convenient to families and small businesses in one of Arlington's most established and affluent areas, the office offers extended weekday and Saturday hours, as well as an ATM.

The Arlington office joins Cardinal Bank's other banking facilities in Alexandria, Fairfax, Manassas, McLean, Reston, Sterling and Tysons Corner. Long-term strategy includes the establishment of additional banking offices. Cardinal will also enhance its ability to assess customer needs and take advantage of relationship-building opportunities through systems and branch intelligence upgrades.



The new Arlington banking office team includes Catherine Johnson, Shamira Darko and Brad Leiby.

Cardinal Bank places a major emphasis on Retail Banking and is now attracting more and more families and individuals as depositors and borrowers. Retail Banking is an important part of our present and future growth, and our ultimate success. Retail Banking will provide the market share expansion Cardinal seeks, especially as the Bank expands into new neighborhoods.

As a community bank, Cardinal is proud of its emphasis on personal service, competitive products, attractive pricing and convenient access. During the year, the Bank made major strides in service offerings and has taken the first steps to expand its branch network into other areas with the opening of its first banking office in Arlington County.

Total deposits rose by 72 percent in 2002, aided by marketing the *President's Club Checking Relationship Package*, which has paid a rate of interest well above other interest-bearing checking plans in the market. Also highly promoted was *Totally Free Checking*, which gives consumers an affordable alternative with all the convenience and value they deserve for their checking needs. Deposit growth was evident in all branches. The Fairfax office well surpassed the \$100 million level in deposits—a milestone that very few bank branches achieve.

In the consumer lending area, the Bank successfully introduced a very attractive and competitive line-of-credit product that offered customers a market-low, six-month introductory rate, followed by an ongoing rate of prime minus one-half percent. This outstanding line-of-credit offer, combined with fixed-term-and-rate options, is among the best in the market, providing the retail lending success projected. Cardinal's home equity products were met with excellent consumer acceptance and are further enhanced by the Bank's reputation as a financial services organization that provides great service, flexible choices, and excellent value.



## COMMERCIAL LENDING

Cardinal Bank's commercial lending team has more than 300 years of combined lending experience. For our clients, however, this experience is evident in the quality of service, responsiveness to loan requests, and the understanding of the specific needs of industry segments in the Northern Virginia region. Through a continued strong emphasis on commercial lending, Cardinal Bank's loan portfolio grew by more than 20 percent in 2002.

With a lending limit over \$5 million, Cardinal Bank is able to handle credit needs well beyond the capabilities of most community banks, allowing the bank to support clients as they grow. Unlike larger institutions headquartered outside the region, all lending decisions are made by experienced, local lenders. Cardinal believes this powerful combination offers businesses the best of both worlds—a bank with the experience and the capacity to take on large, complex lending requests, and a bank with the local focus to ensure that decisions are made quickly.

Cardinal Bank serves a wide range of commercial clients, building contractors, and small businesses with special expertise among not-for-profit associations—churches and clubs; medical and professional practices; government contractors and distributors. Cardinal offers these and other client groups affordable lending options, as well as sophisticated computer-based treasury management services that rival those offered by larger commercial banks.

Although technology is a critical part of our service offering, the real difference lies in the quality of Cardinal's professionals—lenders who listen first...lenders who are creative thinkers...lenders who are problem-solvers. Local businesses face many challenges. The role of Cardinal Bank is to anticipate client needs and then provide solutions and support to help clients grow and succeed.

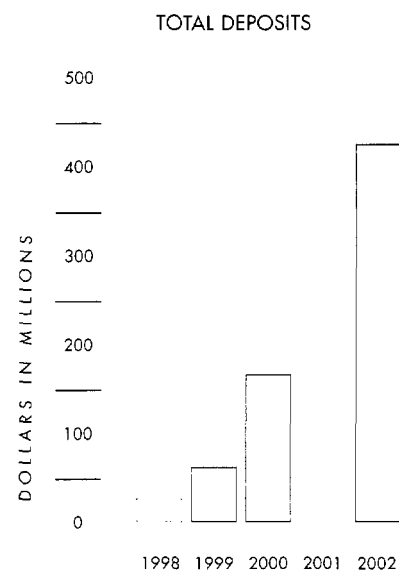
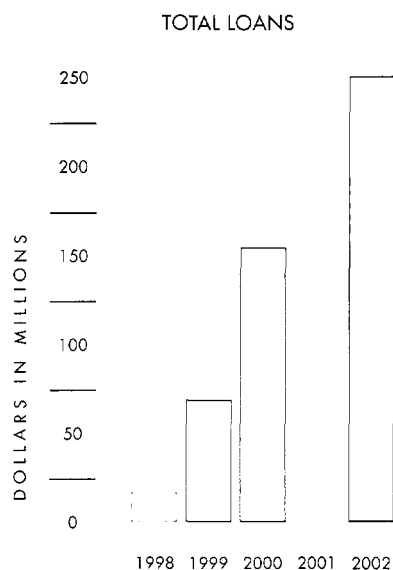
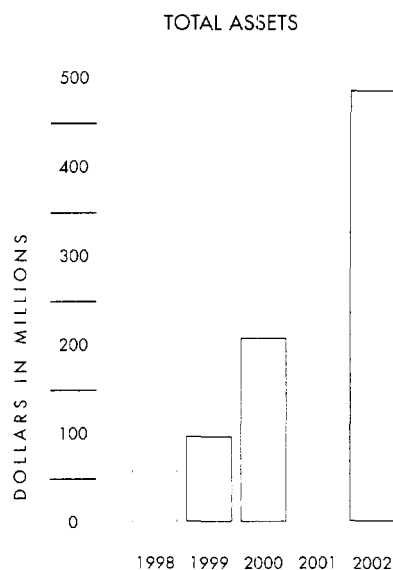


Chris Bergstrom, President; Cheryl Beebe, Senior Vice President, Commercial Lending; and Kevin Reynolds, President

## Financial Highlights

| Results of Operations                               | 2002       | Years Ended December 31,<br>2001 | 2000       |
|---|------------|----------------------------------|------------|
| <i>(Dollars in thousands except per share data)</i> |            |                                  |            |
| Net loss  | \$ (529)   | \$ (12,724)                      | \$ (3,971) |
| Dividends to preferred shareholders                 | 495        | 503                              | 171        |
| Net loss to common shareholders                     | \$ (1,024) | \$ (13,227)                      | \$ (4,142) |
| Return on average assets                            | (0.14%)    | (5.24%)                          | (2.72%)    |
| Return on average equity                            | (1.61%)    | (39.14%)                         | (12.72%)   |
| <b>Per Common Share</b>                             |            |                                  |            |
| Net loss - basic and diluted                        | \$ (0.13)  | \$ (3.11)                        | \$ (0.98)  |
| Book value  | 3.37       | 3.21                             | 6.36       |
| Tangible book value                                 | 3.31       | 3.06                             | 4.11       |

| Financial Condition       | 2002       | As of December 31,<br>2001 | 2000       |
|---------------------------|------------|----------------------------|------------|
| <i>At Year End</i>        |            |                            |            |
| Total assets              | \$ 486,323 | \$ 279,584                 | \$ 207,048 |
| Loans receivable, net     | 245,734    | 197,807                    | 152,371    |
| Deposits                  | 423,479    | 246,024                    | 163,371    |
| Shareholders' equity      |            |                            |            |
| Tier I capital            | \$ 37,721  | \$ 20,230                  | \$ 34,102  |
| Ratio                     | 12.25%     | 9.04%                      | 18.89%     |
| Tier I & II capital       | \$ 41,093  | \$ 23,333                  | \$ 36,002  |
| Ratio                     | 13.35%     | 10.42%                     | 19.94%     |
| Common shares outstanding | 10,044,345 | 4,294,323                  | 4,253,155  |



## Selected Financial Information

(Dollars in thousands, except share and per share data)

For the Years Ended December 31,

|   | 2002       | 2001       | 2000       | 1999      | 1998      |
|---|------------|------------|------------|-----------|-----------|
| <b>Results of Operations</b>                        |            |            |            |           |           |
| Interest and dividend income                        | \$ 20,242  | \$ 16,577  | \$ 11,150  | \$ 4,330  | \$ 1,556  |
| Interest expense                                    | 9,586      | 7,500      | 4,740      | 1,305     | 340       |
| Net interest income                                 | 10,656     | 9,077      | 6,410      | 3,025     | 1,216     |
| Provision for loan losses                           | 444        | 1,202      | 753        | 514       | 212       |
| Net interest income after provision for loan losses | 10,212     | 7,875      | 5,657      | 2,511     | 1,004     |
| Non-interest income                                 | 3,273      | 3,267      | 2,098      | 1,320     | 34        |
| Non-interest expense                                | 14,014     | 23,866     | 11,726     | 7,870     | 2,734     |
| Net loss before income taxes                        | (529)      | (12,724)   | (3,971)    | (4,039)   | (1,696)   |
| Provision for income taxes                          | —          | —          | —          | —         | —         |
| Net loss  | (529)      | (12,724)   | (3,971)    | (4,039)   | (1,696)   |
| Dividends to preferred shareholders                 | 495        | 503        | 171        | —         | —         |
| Net loss to common shareholders                     | (1,024)    | (13,227)   | (4,142)    | (4,039)   | (1,696)   |
| <b>Loss Per Common Share</b>                        |            |            |            |           |           |
| Basic & diluted:                                    |            |            |            |           |           |
| Net loss  | \$ (0.13)  | \$ (3.11)  | \$ (0.98)  | \$ (0.95) | \$ (0.64) |
| Average shares outstanding                          | 7,949,132  | 4,258,087  | 4,246,346  | 4,240,819 | 2,646,036 |
| Dividends paid per common share                     | \$ —       | \$ —       | \$ —       | \$ —      | \$ —      |
| <b>Financial Condition</b>                          |            |            |            |           |           |
| <b>Selected Average Balances</b>                    |            |            |            |           |           |
| Total assets  | \$ 388,826 | \$ 242,732 | \$ 146,093 | \$ 71,987 | \$ 31,604 |
| Earning assets                                      | 365,269    | 217,881    | 132,863    | 65,945    | 26,925    |
| Loans receivable, net                               | 203,594    | 178,901    | 102,785    | 33,265    | 1,948     |
| Deposits  | 348,141    | 197,434    | 105,931    | 36,132    | 8,347     |
| Other borrowed funds                                | 5,564      | 10,002     | 6,904      | 1,773     | —         |
| Total shareholders' equity                          | 32,839     | 32,506     | 31,215     | 32,942    | 22,783    |
| <b>At December 31</b>                               |            |            |            |           |           |
| Total assets  | \$ 486,323 | \$ 279,584 | \$ 207,048 | \$ 97,033 | \$ 57,295 |
| Earning assets                                      | 450,292    | 264,071    | 187,281    | 89,563    | 54,317    |
| Loans receivable, net                               | 245,734    | 197,807    | 152,371    | 67,441    | 16,115    |
| Deposits  | 423,479    | 246,024    | 163,371    | 59,873    | 21,867    |
| Other borrowed funds                                | 2,000      | 9,824      | 7,287      | 6,000     | —         |
| Total shareholders' equity                          | 40,712     | 20,624     | 34,112     | 30,745    | 34,728    |
| <b>Selected Ratios and Other Data</b>               |            |            |            |           |           |
| Return on average assets                            | (0.14%)    | (5.24%)    | (2.72%)    | (5.61%)   | (5.37%)   |
| Return on average equity                            | (1.61%)    | (39.14%)   | (12.72%)   | (12.26%)  | (7.44%)   |
| Net interest margin                                 | 2.92%      | 4.17%      | 4.82%      | 4.59%     | 4.66%     |
| Net interest spread                                 | 2.27%      | 2.90%      | 2.85%      | 2.30%     | 1.09%     |
| Total shareholders' equity to total assets          | 8.37%      | 7.38%      | 16.48%     | 31.69%    | 60.61%    |
| Allowance to year end loans                         | 1.35%      | 1.54%      | 1.23%      | 1.07%     | 1.30%     |
| Non-performing assets to total loans                | 0.37%      | 0.18%      | 0.38%      | 0.00%     | 0.00%     |
| Based on averages:                                  |            |            |            |           |           |
| Total equity to total assets                        | 8.45%      | 13.39%     | 21.37%     | 45.76%    | 72.09%    |
| Total loans to total equity                         | 629.29%    | 556.88%    | 333.07%    | 102.23%   | 8.65%     |
| Full-time equivalent employees                      | 107        | 100        | 131        | 82        | 30        |

## Management's Discussion and Analysis of Financial Condition and Results of Operations

The following presents management's discussion and analysis of our consolidated financial condition for the years ended December 31, 2002 and 2001 and the results of our operations for the years ended December 31, 2002, 2001 and 2000. The discussion should be read in conjunction with the accompanying consolidated financial statements.

### Company Overview

Cardinal Financial Corporation is a locally owned and managed financial services organization headquartered in Northern Virginia and committed to providing top quality customer service, a diversified product mix and convenient avenues for banking to consumers and businesses. During 2002, total assets increased 74.0% to \$486.3 million. As of December 31, 2002, net loans receivable increased 24.2% to \$245.7 million. In just over four years of operations, we have become one of the largest banks headquartered in our market measured by deposits. Total deposits increased 72.1% to \$423.5 million as of December 31, 2002. Our investment advisory subsidiary, Cardinal Wealth Services, Inc., ended 2002 with over 2,000 customers and assets under management exceeding \$98.8 million.

### Critical Accounting Policies

#### *Allowance for Loan Losses*

We maintain the allowance for loan losses at a level that represents management's best estimate of known and inherent losses in the loan portfolio. Both the amount of the provision expense and the level of the allowance for loan losses are impacted by many factors, including general economic conditions, actual and expected credit losses, historical trends and specific conditions of the individual borrower. As a part of our analysis, we use comparative peer group data, duration factors and qualitative factors such as levels of and trends in delinquencies and nonaccrual loans, national and local economic trends and conditions and concentrations of loans exhibiting similar risk profiles to support our estimates. The loan loss provision for the years ended December 31, 2002, 2001 and 2000 was \$444,000, \$1.2 million and \$753,000, respectively. The allowance for loan loss increased slightly to \$3.4 million as of December 31, 2002 from \$3.1 million as of December 31, 2001. The ratio of the allowance for loan losses to total loans, net of fees, was 1.35% at December 31, 2002 compared to 1.54% at December 31, 2001. Additional information on the allowance for loan losses and provision expense can be found later in this discussion under "Provision Expense and Allowance for Loan Losses."

Credit losses are an inherent part of our business and, although we believe the methodologies for determining the allowance for loan losses and the current level of the allowance are adequate, it is possible that there may be unidentified losses in the portfolio that may become evident only at a future date. Additional provisions for such losses, if necessary, would negatively impact earnings and would be recorded in the banking business segment.

We categorize our loans into one of five pools: commercial and industrial, commercial real estate, home equity lines of credit, residential mortgages, and consumer loans. Peer group annual loss factors (in the absence of historical results) are applied to all pools and are adjusted by the projected duration of the loan pool and by the qualitative factors mentioned above. The indicated loss factors resulting from this analysis are applied to each of the loan pools to determine a reserve level for each of the five pools of loans. In addition, we individually assign loss factors to all loans that have been identified as having loss attributes, as indicated by deterioration in the financial condition of the borrower or a decline in underlying collateral values. Since we have limited historical data on which to base loss factors for classified loans, we apply a 5% loss factor to all special mention loans and a 15% loss factor to all substandard loans (in accordance with regulatory guidelines).

#### *Valuation Allowance for Deferred Tax Assets*

Deferred income taxes reflect temporary differences in the recognition of revenue and expenses for tax reporting and financial statement purposes, principally because certain items, such as depreciation and amortization, are recognized in different periods for financial reporting and tax return

purposes. A valuation allowance has been established for deferred tax assets, as realization is dependent upon generating future taxable income. Additional information on the valuation allowance can be found in Footnote 9 to the Notes to Consolidation Financial Statements.

#### *New Financial Accounting Standards*

During 2002, the Financial Accounting Standards Board issued several new accounting pronouncements which are summarized below. These new pronouncements have had no impact on our financial results nor are they expected to have a material impact.

SFAS No. 145, "Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections," was issued in May 2002. SFAS No. 145 rescinds FASB Statement No. 4, "Reporting Gains and Losses from Extinguishment of Debt," as well as an amendment of that Statement, FASB Statement No. 64, "Accounting for Intangible Assets of Motor Carriers," and amends FASB Statement No. 13, "Accounting for Leases," to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. In addition, SFAS No. 145 amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions.

SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," was issued in June 2002. It addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force EITF Issue 94-3 (EITF 94-3), "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity." Unlike EITF 94-3, SFAS No. 146 requires that a liability for a cost associated with an exit or disposal activity be recognized when that liability is incurred rather than at the date of an entity's commitment to an exit plan.

SFAS No. 147, "Acquisitions of Certain Financial Institutions," amends FASB Statement No. 72 and 144 and FASB Interpretation No. 9, and was issued in July 2002. It removes acquisitions of financial institutions from the scope of both Statement No. 72 and Interpretation No. 9, except for transactions between two or more mutual enterprises. Instead, it requires that acquisitions of financial institutions be accounted for in accordance with SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets."

SFAS No. 148, "Accounting for Stock-Based Compensation- Transition and Disclosure, an amendment of FASB Statement No. 123," was issued in December 2002. It amends SFAS No. 123, "Accounting for Stock Based Compensation," to provide alternative methods of transition for an entity that voluntarily adopts the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provision of SFAS No. 123 to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. Finally, this statement amends APB Opinion 28, "Interim Financial Reporting," to require disclosure about those effects in interim financial information.

#### **2002 Compared to 2001**

Our net loss for the year ended December 31, 2002 totaled \$1.0 million or \$0.13 per common share, compared with a loss of \$13.2 million or \$3.11 per common share for the same period of 2001. Included in the reported net loss for the year ended December 31, 2002 were two quarters (3rd and 4th quarters) of net income totaling \$390,000 or \$0.04 per common share. The 2002 loss included an impairment of \$1.7 million of an investment in a WorldCom bond. If the impact of the WorldCom impairment were excluded, we would have reported net income of \$636,000, or \$0.08 per common share for the year ended December 31, 2002 (see Table 1 for a reconciliation of GAAP to Non-GAAP Financial Measures). All year-end results are presented after the effect of dividends paid to preferred share-

## Management's Discussion and Analysis of Financial Condition and Results of Operations

holders of \$495,000 and \$503,000 for the years ended December 31, 2002 and 2001, respectively. The return on average assets for the years ended December 31, 2002, 2001 and 2000 were (0.14%), (5.24%) and (2.72%), respectively. The return on average equity for the years ended December 31, 2002, 2001 and 2000 were (1.61%), (39.14%) and (12.72%), respectively.

Total assets increased \$206.7 million, or 74.0%, to \$486.3 million at December 31, 2002 compared to \$279.6 million at December 31, 2001. Asset growth was funded primarily by deposit growth of \$177.5 million, or 72.1%, to \$423.5 million at December 31, 2002. The strong growth experienced during 2002 is attributed to aggressive promotion of our products through advertising and direct mail in addition to opening our eighth branch in Arlington, Virginia during the fourth quarter of 2002.

Total shareholders' equity increased \$20.1 million or 97.4% to \$40.7 million at December 31, 2002 compared to \$20.6 million at December 31, 2001. This increase was primarily a result of our successful \$18.5 million rights and secondary offerings during the second quarter of 2002. Book value per common share increased to \$3.37 at December 31, 2002 compared to \$3.21 at December 31, 2001. The ratio of total capital to risk based assets increased to 13.35% at December 31, 2002 compared to 10.42% at December 31, 2001 giving us a well-capitalized position for regulatory purposes going into 2003. Total shareholders' equity to total assets at December 31, 2002, 2001 and 2000 were 8.4%, 7.4% and 16.5%, respectively.

**Table 1**

**Reconciliation of GAAP to Non-GAAP Financial Measures**  
Years Ended December 31, 2002, 2001 and 2000  
(Dollars in thousands, except per share data)

|   | 2002           | 2001              | 2000              |
|---|----------------|-------------------|-------------------|
| Reported net loss to common shareholders                              | \$ (1,024)     | \$ (13,227)       | \$ (4,142)        |
| Less nonrecurring expenses:   |                |                   |                   |
| Writedown of WorldCom Bond  | 1,660          | —                 | —                 |
| Impairment of Heritage Bancorp goodwill                               | —              | 8,264             | —                 |
| Restructuring costs   | —              | 884               | —                 |
| <b>Net income (loss) without nonrecurring expenses</b>                | <b>\$ 636</b>  | <b>\$ (4,079)</b> | <b>\$ (4,142)</b> |
| Reported net loss per common share                                    | \$ (0.13)      | \$ (3.11)         | \$ (0.98)         |
| Less nonrecurring expenses:   |                |                   |                   |
| Writedown of WorldCom Bond  | 0.21           | —                 | —                 |
| Impairment of Heritage Bancorp goodwill                               | —              | 1.94              | —                 |
| Restructuring costs   | —              | 0.21              | —                 |
| <b>Earnings (loss) per common share without nonrecurring expenses</b> | <b>\$ 0.08</b> | <b>\$ (0.96)</b>  | <b>\$ (0.98)</b>  |

### Statements of Operations

#### Net Interest Income/Margin

Net interest income is our primary source of revenue, representing the difference between interest and fees earned on interest-bearing assets and the interest paid on deposits and other interest-bearing liabilities. The level of net interest income is impacted primarily by variations in the volume and mix of these assets and liabilities, as well as changes in interest rates when compared to previous periods of operations. During 2002, we continued to experience a weakened economy that had entered into a recessionary phase early in 2001. During 2001, the Federal Reserve lowered rates eleven times in order to turn the economy around from its recessionary phase. During the fourth quarter of 2002, in response to this weakening economy and the lack of any inflationary pressures, the Federal Reserve lowered rates an additional 50 basis points. At 4.25%, the prime lending rate is at its lowest levels in over forty years. We expect that 2003 will be another year of slow economic growth in the financial markets with little to no change in interest rates.

Net interest income was \$10.7 million in 2002, up \$1.6 million or 17.4% from 2001. The increase is primarily due to the increase in loans and investment securities available-for-sale during 2002, funded through the increase in total deposits and shareholders' equity. The increase in net interest income was tempered by a reduction in our net interest margin, due primarily to the continued decline in yields on earnings assets at a faster pace than the decline in yields on interest bearing liabilities.

The net interest margin was 2.92% for the year ended December 31, 2002 as compared to 4.17% for the same period of 2001. The decrease in the net interest margin is representative of the change in the mix of earning assets towards lower yielding investments and to the lower rate environment experienced during 2002. The rate on interest earning assets decreased to 5.54% in 2002 from 7.61% in 2001 and our cost on interest-bearing liabilities decreased to 3.27% in 2002 from 4.71% in 2001.

Total earning assets increased by 70.5% to \$450.3 million at December 31, 2002 as compared to \$264.1 million at December 31, 2001. This increase consisted mainly of a \$47.9 million, or 24.2% increase in net loans receivable, and a \$129.5 million, or 379.3%, increase in investment securities available-for-sale. These increases were primarily funded by total deposit growth of \$177.5 million or 72.1% over December 31, 2001 balances.

Average investment securities available-for-sale increased \$94.6 million to \$101.6 million during 2002, funded primarily by the increase in average deposits of \$150.7 million during 2002 compared to 2001.

Average total loans increased \$25.6 million to \$206.7 million during 2002 from \$181.0 million in 2001. Average balances for nonperforming assets, which consist of nonaccrual loans, are included in the net interest margin calculation and did not have a material impact on our net interest margin in 2002 and 2001. Additional interest income of approximately \$37,000 for 2002 and \$17,000 for 2001 would have been realized had all nonperforming assets performed as originally expected. Nonperforming assets exclude loans that are both past due 90 days or more and still accruing interest due to an assessment of collectibility.

Average total deposits increased \$150.7 million to \$348.1 million in 2002 from \$197.4 million in 2001. The largest increase in average deposit balances was experienced in interest checking, an increase of \$96.7 million compared to 2001, as a result of our President's Club relationship account promotion.

Tables 2 and 3 contain more detailed information concerning average balances, yields earned, and rates paid.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

**Table 2**

**Average Balance Sheets and Interest Rates on Earning Assets and Interest – Bearing Liabilities**  
As of and for the Years Ended December 31, 2002, 2001 and 2000  
(Dollars in thousands)

|   | 2002               |                                |       | 2001               |                                |       | 2000               |                                |        |
|---|--------------------|--------------------------------|-------|--------------------|--------------------------------|-------|--------------------|--------------------------------|--------|
|   | Average<br>Balance | Interest<br>Income/<br>Expense | Rate  | Average<br>Balance | Interest<br>Income/<br>Expense | Rate  | Average<br>Balance | Interest<br>Income/<br>Expense | Rate   |
| <b>Assets</b>   |                    |                                |       |                    |                                |       |                    |                                |        |
| Interest-earning assets:                                |                    |                                |       |                    |                                |       |                    |                                |        |
| Loans:  |                    |                                |       |                    |                                |       |                    |                                |        |
| Commercial  | \$ 52,960          | \$ 3,696                       | 6.98% | \$ 52,063          | \$ 4,407                       | 8.46% | \$ 35,605          | \$ 3,149                       | 8.84%  |
| Real estate – commercial                                | 91,289             | 7,276                          | 7.97% | 72,500             | 6,288                          | 8.67% | 33,546             | 2,899                          | 8.64%  |
| Real estate – construction                              | 6,156              | 375                            | 6.09% | 5,634              | 487                            | 8.64% | 2,425              | 287                            | 11.84% |
| Real estate – residential                               | 20,139             | 1,534                          | 7.62% | 17,972             | 1,501                          | 8.35% | 15,568             | 1,447                          | 9.29%  |
| Home equity lines                                       | 23,711             | 993                            | 4.19% | 18,023             | 1,146                          | 6.36% | 7,307              | 698                            | 9.55%  |
| Consumer  | 12,399             | 924                            | 7.45% | 14,827             | 1,144                          | 7.72% | 9,518              | 778                            | 8.17%  |
| Total loans   | 206,654            | 14,798                         | 7.16% | 181,019            | 14,973                         | 8.27% | 103,969            | 9,258                          | 8.90%  |
| Investment securities available-for-sale                | 101,589            | 4,501                          | 4.43% | 7,022              | 437                            | 6.22% | 6,068              | 371                            | 6.11%  |
| Other investments                                       | 1,253              | 72                             | 5.75% | 1,373              | 82                             | 5.97% | 1,036              | 70                             | 6.76%  |
| Federal funds sold                                      | 55,773             | 871                            | 1.56% | 28,467             | 1,085                          | 3.81% | 21,790             | 1,451                          | 6.66%  |
| Total interest-earning assets and interest income       | 365,269            | 20,242                         | 5.54% | 217,881            | 16,577                         | 7.61% | 132,863            | 11,150                         | 8.39%  |
| Non-interest earning assets:                            |                    |                                |       |                    |                                |       |                    |                                |        |
| Cash and due from banks                                 | 18,595             |                                |       | 10,467             |                                |       | 5,890              |                                |        |
| Premises and equipment, net                             | 4,820              |                                |       | 5,579              |                                |       | 4,698              |                                |        |
| Goodwill and other intangibles                          | 651                |                                |       | 9,228              |                                |       | 3,262              |                                |        |
| Accrued interest and other assets                       | 2,551              |                                |       | 1,695              |                                |       | 564                |                                |        |
| Allowance for loan losses                               | (3,060)            |                                |       | (2,118)            |                                |       | (1,184)            |                                |        |
| Total assets  | \$ 388,826         |                                |       | \$ 242,732         |                                |       | \$ 146,093         |                                |        |
| <b>Liabilities and Shareholders' Equity</b>             |                    |                                |       |                    |                                |       |                    |                                |        |
| Interest – bearing liabilities:                         |                    |                                |       |                    |                                |       |                    |                                |        |
| Interest – bearing deposits:                            |                    |                                |       |                    |                                |       |                    |                                |        |
| Interest checking                                       | 114,350            | 3,073                          | 2.69% | 17,675             | 370                            | 2.09% | 5,375              | 130                            | 2.42%  |
| Money markets   | 28,667             | 525                            | 1.83% | 25,346             | 767                            | 3.03% | 15,256             | 624                            | 4.09%  |
| Statement savings                                       | 4,305              | 52                             | 1.21% | 4,371              | 102                            | 2.33% | 2,441              | 61                             | 2.50%  |
| Certificates of deposit                                 | 140,033            | 5,714                          | 4.08% | 101,932            | 5,788                          | 5.68% | 55,656             | 3,478                          | 6.25%  |
| Total interest – bearing deposits                       | 287,355            | 9,364                          | 3.26% | 149,324            | 7,027                          | 4.71% | 78,728             | 4,293                          | 5.45%  |
| Other borrowed funds                                    | 5,564              | 222                            | 3.99% | 10,002             | 473                            | 4.73% | 6,904              | 447                            | 6.47%  |
| Total interest-bearing liabilities and interest expense | 292,919            | 9,586                          | 3.27% | 159,326            | 7,500                          | 4.71% | 85,632             | 4,740                          | 5.54%  |
| Noninterest-bearing liabilities:                        |                    |                                |       |                    |                                |       |                    |                                |        |
| Demand deposits   | 60,786             |                                |       | 48,110             |                                |       | 27,203             |                                |        |
| Other liabilities                                       | 2,282              |                                |       | 2,790              |                                |       | 2,043              |                                |        |
| Preferred shareholders' equity                          | 6,825              |                                |       | 7,056              |                                |       | 2,371              |                                |        |
| Common shareholders' equity                             | 26,014             |                                |       | 25,450             |                                |       | 28,844             |                                |        |
| Total liabilities and shareholders' equity              | \$ 388,826         |                                |       | \$ 242,732         |                                |       | \$ 146,093         |                                |        |
| Net interest income and net interest margin             |                    |                                |       |                    |                                |       |                    |                                |        |
|   |                    | \$ 10,656                      | 2.92% |                    | \$ 9,077                       | 4.17% |                    | \$ 6,410                       | 4.82%  |

## Management's Discussion and Analysis of Financial Condition and Results of Operations

**Table 3**

**Rate and Volume Analysis (Tax Equivalent Basis)**

Years Ended December 31, 2002, 2001 and 2000

(Dollars in thousands)

|  | 2002 Compared to 2001 |                 |                        | 2001 Compared to 2000 |                 |                        |
|--|-----------------------|-----------------|------------------------|-----------------------|-----------------|------------------------|
|  | Average<br>Volume     | Average<br>Rate | Increase<br>(Decrease) | Average<br>Volume     | Average<br>Rate | Increase<br>(Decrease) |
| <b>Interest income:</b>                  |                       |                 |                        |                       |                 |                        |
| Loans:                                   |                       |                 |                        |                       |                 |                        |
| Commercial                               | \$ 76                 | \$ (787)        | \$ (711)               | \$ 1,456              | \$ (198)        | \$ 1,258               |
| Real estate – commercial                 | 1,630                 | (642)           | 988                    | 3,366                 | 23              | 3,389                  |
| Real estate – construction               | 45                    | (157)           | (112)                  | 380                   | (180)           | 200                    |
| Real estate – residential                | 181                   | (148)           | 33                     | 223                   | (169)           | 54                     |
| Home equity lines                        | 362                   | (515)           | (153)                  | 1,024                 | (576)           | 448                    |
| Consumer                                 | (187)                 | (33)            | (220)                  | 434                   | (68)            | 366                    |
| Total loans                              | 2,107                 | (2,282)         | (175)                  | 6,883                 | (1,168)         | 5,715                  |
| Investment securities available for sale | 5,885                 | (1,821)         | 4,064                  | 58                    | 8               | 66                     |
| Other investments                        | (7)                   | (3)             | (10)                   | 23                    | (11)            | 12                     |
| Federal funds sold                       | 1,041                 | (1,255)         | (214)                  | 445                   | (811)           | (366)                  |
| Total interest income                    | 9,026                 | (5,361)         | 3,665                  | 7,409                 | (1,982)         | 5,427                  |
| <b>Interest expense:</b>                 |                       |                 |                        |                       |                 |                        |
| Interest – bearing deposits:             |                       |                 |                        |                       |                 |                        |
| Interest checking                        | 2,024                 | 679             | 2,703                  | 297                   | (57)            | 240                    |
| Money markets                            | 100                   | (342)           | (242)                  | 413                   | (270)           | 143                    |
| Statement savings                        | (2)                   | (48)            | (50)                   | 48                    | (7)             | 41                     |
| Certificates of deposit                  | 2,163                 | (2,237)         | (74)                   | 2,893                 | (583)           | 2,310                  |
| Total interest – bearing deposits        | 4,285                 | (1,948)         | 2,337                  | 3,651                 | (917)           | 2,734                  |
| Other borrowed funds                     | (210)                 | (41)            | (251)                  | 201                   | (175)           | 26                     |
| Total interest expense                   | 4,075                 | (1,989)         | 2,086                  | 3,852                 | (1,092)         | 2,760                  |
| Net interest income                      | \$ 4,951              | \$ (3,372)      | \$ 1,579               | \$ 3,557              | \$ (890)        | \$ 2,667               |

## Management's Discussion and Analysis of Financial Condition and Results of Operations

### Provision Expense and Allowance for Loan Losses

Our policy is to maintain the allowance for loan losses at a level that represents our best estimate of known and inherent losses in the loan portfolio. Both the amount of the provision and the level of the allowance for loan losses are impacted by many factors, including general economic conditions, actual and expected credit losses, historical trends and specific conditions of the individual borrower. Provision for loan losses was \$444,000 in 2002 as compared to \$1.2 million in 2001 due primarily to the strong loan quality experienced and a change in our portfolio mix with increases in our residential and home equity loan portfolios, which require lower reserve amounts than the remainder of the loan portfolio.

The allowance for loan losses increased to \$3.4 million in 2002 from \$3.1 million in 2001. The ratio of the allowance for loan losses to total loans, net of fees, at December 31, 2002 was 1.35% compared to 1.54% at December 31, 2001. We experienced loan charge offs of \$117,000 for the year ended December 31, 2002 offset by recoveries of \$15,000. We had no charge offs prior to 2002.

Tables 4 and 5 contain additional information pertaining to the calculation and allocation of the allowance for loan losses.

**Table 4**

### Allowance for Loan Losses

As of December 31, 2002, 2001, 2000, 1999 and 1998

(Dollars in thousands)

|  | 2002     | 2001     | 2000     | 1999   | 1998   |
|--|----------|----------|----------|--------|--------|
| Beginning balance, January 1   | \$ 3,104 | \$ 1,900 | \$ 726   | \$ 212 | \$ —   |
| Provision for loan losses  | 444      | 1,202    | 753      | 514    | 212    |
| Transfer to bank's liability on unfunded commitments                         | (74)     | —        | —        | —      | —      |
| Assumed allowance for loan losses from acquisition of Heritage Bancorp, Inc. | —        | —        | 421      | —      | —      |
| Loans charged off:   |          |          |          |        |        |
| Commercial   | (63)     | —        | —        | —      | —      |
| Real estate – commercial   | —        | —        | —        | —      | —      |
| Real estate – construction   | —        | —        | —        | —      | —      |
| Real estate – residential  | —        | —        | —        | —      | —      |
| Home equity lines  | —        | —        | —        | —      | —      |
| Consumer   | (54)     | —        | —        | —      | —      |
| Total loans charged off  | (117)    | —        | —        | —      | —      |
| Recoveries:  |          |          |          |        |        |
| Commercial   | 12       | 2        | —        | —      | —      |
| Real estate – commercial   | —        | —        | —        | —      | —      |
| Real estate – construction   | —        | —        | —        | —      | —      |
| Real estate – residential  | —        | —        | —        | —      | —      |
| Home equity lines  | —        | —        | —        | —      | —      |
| Consumer   | 3        | —        | —        | —      | —      |
| Total recoveries   | 15       | 2        | —        | —      | —      |
| Net (charge offs) recoveries   | (102)    | 2        | —        | —      | —      |
| Ending balance, December 31,   | \$ 3,372 | \$ 3,104 | \$ 1,900 | \$ 726 | \$ 212 |

| Loans:                                      | 2002       | 2001       | 2000       | 1999      | 1998      |
|---|------------|------------|------------|-----------|-----------|
| Balance at year end                         | \$ 249,106 | \$ 200,911 | \$ 154,271 | \$ 68,167 | \$ 16,327 |
| Allowance for loan losses to year end loans | 1.35%      | 1.54%      | 1.23%      | 1.07%     | 1.30%     |



## Management's Discussion and Analysis of Financial Condition and Results of Operations

Table 5 shows the allocation of the allowance for loan losses by loan type and the percentage of the loan type to the total loan portfolio.

**Table 5**

**Allocation of the Allowance for Loan Losses**

As of December 31, 2002, 2001, 2000, 1999 and 1998

(Dollars in thousands)

|                                 | 2002       |             | 2001       |             | 2000       |             |
|---------------------------------|------------|-------------|------------|-------------|------------|-------------|
|                                 | Allocation | % of Total* | Allocation | % of Total* | Allocation | % of Total* |
| Commercial                      | \$ 1,301   | 23.40%      | \$ 1,149   | 28.71%      | \$ 612     | 32.22%      |
| Real estate – commercial        | 1,386      | 46.63%      | 1,270      | 43.37%      | 678        | 37.05%      |
| Real estate – construction      | 19         | 2.32%       | 34         | 3.18%       | 50         | 2.65%       |
| Real estate – residential       | 241        | 12.77%      | 98         | 7.20%       | 181        | 11.51%      |
| Home equity lines               | 201        | 10.77%      | 176        | 10.60%      | 126        | 9.65%       |
| Consumer                        | 224        | 4.11%       | 377        | 6.94%       | 253        | 6.92%       |
| Total allowance for loan losses | \$ 3,372   | 100.00%     | \$ 3,104   | 100.00%     | \$ 1,900   | 100.00%     |

|                                 | 1999       |             | 1998       |             |
|---------------------------------|------------|-------------|------------|-------------|
|                                 | Allocation | % of Total* | Allocation | % of Total* |
| Commercial                      | \$ 241     | 33.10%      | \$ 59      | 31.44%      |
| Real estate – commercial        | 211        | 29.03%      | 40         | 21.46%      |
| Real estate – construction      | 9          | 1.28%       | 9          | 4.65%       |
| Real estate – residential       | 126        | 17.39%      | 64         | 33.83%      |
| Home equity lines               | 40         | 5.54%       | 12         | 6.36%       |
| Consumer                        | 99         | 13.66%      | 28         | 2.26%       |
| Total allowance for loan losses | \$ 726     | 100.00%     | \$ 212     | 100.00%     |

\* Percentage of loan type to the total loan portfolio.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

### Non-Interest Income

Non-interest income continues to be an important factor in our operating results. Non-interest income was \$3.3 million for both years ended December 31, 2002 and 2001. Investment fee income from our subsidiary, Cardinal Wealth Services, Inc., decreased by \$1.0 million to \$940,000 for the year ended December 31, 2002 compared to \$1.9 million in 2001. This decrease was a result of the decreased market activity and assets under management experienced during 2002. Due to our increased number of deposit accounts, service charges on deposit accounts increased \$113,000 to \$511,000 during 2002 as compared to \$398,000 in 2001. We had net realized gains on sales of investment securities available-for-sale of \$524,000 for the year ended December 31, 2002 compared to none during 2001. During 2002 and 2001, we consolidated operations, sublet excess space and received rental income of \$409,000, an increase of \$299,000, or 271.8%, from 2001. Table 6 provides additional detail on non-interest income for the years ended December 31, 2002, 2001, and 2000.

Table 6

Non-Interest Income  
Years Ended December 31, 2002, 2001 and 2000  
(Dollars in thousands)

|  | 2002     | 2001     | 2000     |
|--|----------|----------|----------|
| Service charges on deposit accounts                                  | \$ 511   | \$ 398   | \$ 154   |
| Loan service charges   | 392      | 433      | 230      |
| Investment fee income  | 940      | 1,941    | 1,516    |
| Net gain (loss) on sale of loans                                     | 74       | 49       | (23)     |
| Net realized gain (loss) on investment securities available-for-sale | 524      | —        | (32)     |
| Net gain on sales of assets  | 39       | 18       | 57       |
| Rent income  | 409      | 110      | —        |
| ATM transaction fees   | 100      | 92       | 26       |
| Credit card fees   | 46       | 39       | 29       |
| Check order fees   | 101      | 62       | 34       |
| Other income   | 137      | 125      | 107      |
| Total non-interest income  | \$ 3,273 | \$ 3,267 | \$ 2,098 |

### Non-Interest Expense

Non-interest expense was \$14.0 million and \$23.9 million for the years ended December 31, 2002 and 2001, respectively. The decrease in non-interest expense of \$9.9 million, or 41.3% for 2002 compared to 2001 resulted mostly from a one-time charge of \$8.3 million during the fourth quarter of 2001 that substantially eliminated the goodwill attributed to the purchase of Heritage Bancorp, Inc. Also, during 2001, we made the decision to restructure from four banks to one to simplify our structure and reduce costs. Consequently, included in non-interest expense for 2001 is approximately \$884,000 in non-recurring costs associated with the restructuring.

During the second quarter of 2002, we recorded an impairment on an investment in a WorldCom bond of \$1.7 million. Excluding the effect of the one-time charge related to the Heritage Bancorp goodwill in 2001 and the \$1.7 million impairment writedown of the WorldCom bond in 2002, total non-interest expense declined \$3.2 million in 2002 compared to 2001. This substantial decline in non-interest expense was due primarily to decreases in salaries and benefits expense, as well as discontinuation of goodwill

amortization in 2002 due to the implementation of SFAS No. 142, "Goodwill and Other Intangible Assets," and reflects tighter expense controls and improved efficiencies after the consolidation from a multi-bank structure to a one-bank organization. Table 7 reflects the components of non-interest expense for the years ended December 31, 2002, 2001 and 2000.

Table 7

Non-Interest Expense  
Years Ended December 31, 2002, 2001 and 2000  
(Dollars in thousands)

|  | 2002      | 2001      | 2000      |
|--|-----------|-----------|-----------|
| Salary and benefits                        | \$ 5,715  | \$ 7,731  | \$ 6,317  |
| Occupancy                                  | 1,381     | 1,373     | 1,075     |
| Professional fees                          | 1,011     | 705       | 508       |
| Depreciation                               | 736       | 804       | 601       |
| Amortization and write down of intangibles | 22        | 8,907     | 235       |
| Writedown of WorldCom bond                 | 1,660     | —         | —         |
| Data processing                            | 759       | 957       | 561       |
| Stationary and supplies                    | 317       | 306       | 345       |
| Brokerage clearing                         | 206       | 370       | 345       |
| Advertising and marketing                  | 541       | 368       | 241       |
| Telecommunications                         | 276       | 325       | 254       |
| Other taxes                                | 342       | 269       | 221       |
| Travel and entertainment                   | 127       | 164       | 139       |
| Bank operations                            | 411       | 875       | 165       |
| Premises and equipment                     | 271       | 247       | 142       |
| Miscellaneous                              | 239       | 465       | 577       |
| Total non-interest expense                 | \$ 14,014 | \$ 23,866 | \$ 11,726 |

### Income Taxes

We have not recorded income tax expense or benefit due to the availability of net losses in 2002 and all prior years of operations. The ability to utilize net operating loss carryforwards will be dependent on our ability to generate future taxable earnings. Footnote 9 to the Notes to Consolidated Financial Statements provides additional information with respect to the deferred tax accounts and the net operating loss carryforward.

### Statements of Condition

#### Loans Receivable

We have comprehensive policies and procedures that cover both commercial and consumer loan origination and management of credit risk. Loans are underwritten in a manner that focuses on the borrower's ability to repay. Our goal is not to avoid risk, but to manage it and to include credit risk as part of the pricing decision for each product.

Total loans, net of fees and premiums and discounts, increased \$48.2 million to \$249.1 million at December 31, 2002. The strongest growth was in commercial real estate loans and residential real estate loans.

Our loan portfolio has a heavy commercial orientation as evidenced by the information provided in Table 8. We began in late 1999 to better diversify the loan portfolio by purchasing consumer loans. We continued to diversify our portfolio in 2002 and 2001 by establishing a separate retail lending group, creating competitive home equity products, and by purchasing small pools of residential mortgages.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

**Table 8**

**Loans Receivable**

As of December 31, 2002, 2001, 2000, 1999 and 1998

(Dollars in thousands)

|                                 | 2002       |         | 2001       |         | 2000       |         |
|---------------------------------|------------|---------|------------|---------|------------|---------|
| Commercial                      | \$ 58,292  | 23.40%  | \$ 57,665  | 28.71%  | \$ 49,646  | 32.22%  |
| Real estate – commercial        | 116,135    | 46.63%  | 87,116     | 43.37%  | 57,083     | 37.05%  |
| Real estate – construction      | 5,781      | 2.32%   | 6,397      | 3.18%   | 4,088      | 2.65%   |
| Real estate – residential       | 31,808     | 12.77%  | 14,469     | 7.20%   | 17,729     | 11.51%  |
| Home equity lines               | 26,831     | 10.77%  | 21,299     | 10.60%  | 14,867     | 9.65%   |
| Consumer                        | 10,235     | 4.11%   | 13,941     | 6.94%   | 10,665     | 6.92%   |
| Gross loans                     | \$ 249,082 | 100.00% | \$ 200,887 | 100.00% | \$ 154,078 | 100.00% |
| Add: unearned income, net       | 24         |         | 24         |         | 193        |         |
| Less: allowance for loan losses | (3,372)    |         | (3,104)    |         | (1,900)    |         |
| Loans receivable, net           | \$ 245,734 |         | \$ 197,807 |         | \$ 152,371 |         |

|                                 | 1999      |         | 1998      |         |
|---------------------------------|-----------|---------|-----------|---------|
| Commercial                      | \$ 22,558 | 33.10%  | \$ 5,138  | 31.44%  |
| Real estate – commercial        | 19,780    | 29.03%  | 3,507     | 21.46%  |
| Real estate – construction      | 870       | 1.28%   | 760       | 4.65%   |
| Real estate – residential       | 11,851    | 17.39%  | 5,529     | 33.83%  |
| Home equity lines               | 3,777     | 5.54%   | 1,040     | 6.36%   |
| Consumer                        | 9,311     | 13.66%  | 369       | 2.26%   |
| Gross loans                     | \$ 68,147 | 100.00% | \$ 16,343 | 100.00% |
| Add: unearned income, net       | 20        |         | (16)      |         |
| Less: allowance for loan losses | (726)     |         | (212)     |         |
| Loans receivable, net           | \$ 67,441 |         | \$ 16,115 |         |

Loans receivable accounted for on a non-accrual basis at December 31, 2002 and 2001 were \$917,000 and \$361,000, respectively. Accruing loans, which are contractually past due 90 days or more as to principal or interest payments as of December 31, 2002 and 2001, were \$59,000 and \$566,000, respectively. There are no loans as of December 31, 2002 and 2001 included above which are "troubled debt restructurings" as defined in SFAS No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings." Table 9 shows nonperforming loans at the end of each of the past five years. Gross interest income that would have been recorded if the nonaccrual loans had been current with their original terms and had been outstanding throughout the period or since origination if held for part of the period for 2002 was \$37,000. The interest income realized prior to the loans being placed on nonaccrual status for 2002 was \$28,000.

**Table 9**

**Nonperforming Loans Receivable**

As of December 31, 2002, 2001, 2000, 1999 and 1998

(Dollars in thousands)

|  | 2002   | 2001   | 2000   | 1999 | 1998 |
|--|--------|--------|--------|------|------|
| Nonaccruing loans                            | \$ 917 | \$ 361 | \$ 585 | \$ — | \$ — |
| Loans contractually past-due 90 days or more | 59     | 566    | 2      | —    | —    |
| Troubled debt restructurings                 | —      | —      | —      | —    | —    |
| Total nonperforming loans receivable         | \$ 976 | \$ 927 | \$ 587 | \$ — | \$ — |

Specific reserves of \$28,000 were recorded in 2002 for one of the non-accrual loans. Interest income on non-accrual loans, if recognized, is recorded using the cash basis method of accounting. When a loan is placed on non-accrual, unpaid interest is reversed against interest income if it was accrued in the current year and is charged to the allowance for loan losses if it was accrued in prior years. While on non-accrual, the collection of interest is recorded as interest income only after all principal has been collected. When all past contractual obligations are collected and, in our opinion, the borrower has demonstrated the ability to remain current, the loan is returned to an accruing status. At December 31, 2002 the ratio of non-performing loans to total loans was 0.37% as compared to 0.18% at December 31, 2001.

*Investment Securities Available-for-Sale*

Our investment securities portfolio is used as a source of income and liquidity. Investment securities available-for-sale increased to \$163.7 million at December 31, 2002 as compared to \$34.1 million at December 31, 2001. Strong deposit growth during 2002 made more funds available for investments. The portfolio yield decreased from 6.22% as of December 31, 2001 to 4.43% as of December 31, 2002 due to higher yielding investments having matured, been called or sold for a net realized gain and purchases of additional investments during 2002 yielding lower rates. During the second quarter of 2002, we experienced an impairment on an investment in a WorldCom bond that resulted in a charge to non-interest expense of \$1.7 million. Table 10 reflects the composition of the investment portfolio as of December 31, 2002, 2001 and 2000.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

Table 10

Investment Securities Available-for-Sale  
As of December 31, 2002, 2001 and 2000  
(Dollars in thousands)

| As of December 31, 2002                        | Par Value  | Amortized Cost | Fair Value | Unrealized Gain/(Loss) | Average Yield |
|--|------------|----------------|------------|------------------------|---------------|
| U.S. government agencies and enterprises       |            |                |            |                        |               |
| One to five years                              | \$ 26,750  | \$ 26,739      | \$ 26,988  | \$ 249                 | 3.47%         |
| Five to ten years                              | 12,000     | 12,048         | 12,048     | —                      | 3.68%         |
| Total U.S. government agencies                 | \$ 38,750  | \$ 38,787      | \$ 39,036  | \$ 249                 | 3.53%         |
| Mortgage-backed securities                     |            |                |            |                        |               |
| Within one year                                | \$ 15,325  | \$ 15,478      | \$ 15,750  | \$ 272                 | 3.61%         |
| One to five years                              | 69,265     | 70,552         | 72,342     | 1,790                  | 4.82%         |
| Five to ten years                              | 13,385     | 13,695         | 13,686     | (9)                    | 4.43%         |
| After ten years                                | 13,940     | 15,301         | 15,301     | —                      | 5.20%         |
| Total mortgage-backed securities               | \$ 111,915 | \$ 115,026     | \$ 117,079 | \$ 2,053               | 4.65%         |
| Other bonds                                    |            |                |            |                        |               |
| After ten years                                | 5,000      | 5,000          | 5,000      | —                      | 3.39%         |
| Total other bonds                              | \$ 5,000   | \$ 5,000       | \$ 5,000   | \$ —                   | 3.39%         |
| Treasury bonds                                 |            |                |            |                        |               |
| One to five years                              | \$ 2,500   | \$ 2,507       | \$ 2,550   | \$ 43                  | 2.67%         |
| Total treasury bonds                           | \$ 2,500   | \$ 2,507       | \$ 2,550   | \$ 43                  | 2.67%         |
| Total investment securities available-for-sale | \$ 158,165 | \$ 161,320     | \$ 163,665 | \$ 2,345               | 4.32%         |

| As of December 31, 2001                        | Par Value | Amortized Cost | Fair Value | Unrealized Gain/(Loss) | Average Yield |
|--|-----------|----------------|------------|------------------------|---------------|
| U.S. government agencies and enterprises       |           |                |            |                        |               |
| One to five years                              | \$ 3,000  | \$ 2,985       | \$ 2,950   | \$ (35)                | 4.15%         |
| Five to ten years                              | 1,500     | 1,516          | 1,508      | (8)                    | 4.67%         |
| Total U.S. government agencies                 | \$ 4,500  | \$ 4,501       | \$ 4,458   | \$ (43)                | 4.32%         |
| Mortgage-backed securities                     |           |                |            |                        |               |
| Within one year                                | \$ 182    | \$ 182         | \$ 183     | \$ 1                   | 2.55%         |
| One to five years                              | 11,210    | 11,456         | 11,383     | (73)                   | 5.22%         |
| Five to ten years                              | 5,804     | 5,927          | 5,865      | (62)                   | 5.79%         |
| After ten years                                | 4,849     | 4,965          | 4,926      | (39)                   | 5.96%         |
| Total mortgage-backed securities               | \$ 22,045 | \$ 22,530      | \$ 22,357  | \$ (173)               | 5.51%         |
| Corporate bonds                                |           |                |            |                        |               |
| One to five years                              | \$ 6,000  | \$ 6,154       | \$ 6,114   | \$ (40)                | 5.42%         |
| Five to ten years                              | 1,000     | 986            | 969        | (17)                   | 6.98%         |
| Total corporate bonds                          | \$ 7,000  | \$ 7,140       | \$ 7,083   | \$ (57)                | 5.64%         |
| Treasury bonds                                 |           |                |            |                        |               |
| Within one year                                | \$ 250    | \$ 250         | \$ 249     | \$ (1)                 | 1.87%         |
| Total treasury bonds                           | \$ 250    | \$ 250         | \$ 249     | \$ (1)                 | 1.87%         |
| Total investment securities available-for-sale | \$ 33,795 | \$ 34,421      | \$ 34,147  | \$ (274)               | 5.36%         |

## Management's Discussion and Analysis of Financial Condition and Results of Operations

| As of December 31, 2000                        | Par Value | Amortized Cost | Fair Value | Unrealized Gain/(Loss) | Average Yield |
|--|-----------|----------------|------------|------------------------|---------------|
| U.S. government agencies and enterprises       |           |                |            |                        |               |
| Within one year                                | \$ 500    | \$ 500         | \$ 497     | \$ (3)                 | 5.25%         |
| One to five years                              | 4,000     | 3,949          | 3,999      | 50                     | 6.85%         |
| After ten years                                | 1,377     | 1,403          | 1,374      | (29)                   | 6.64%         |
| Total U.S. government agencies                 | \$ 5,877  | \$ 5,852       | \$ 5,870   | \$ 18                  | 6.66%         |
| Mortgage-backed securities                     |           |                |            |                        |               |
| Within one year                                | \$ 30     | \$ 30          | \$ 30      | \$ —                   | 5.50%         |
| One to five years                              | 740       | 742            | 734        | (8)                    | 6.44%         |
| Five to ten years                              | 306       | 307            | 301        | (6)                    | 5.92%         |
| Total mortgage-backed securities               | \$ 1,076  | \$ 1,079       | \$ 1,065   | \$ (14)                | 6.27%         |
| Total investment securities available-for-sale | \$ 6,953  | \$ 6,931       | \$ 6,935   | \$ 4                   | 6.60%         |

### Interest Rate Sensitivity

Our Asset/Liability Committee is responsible for reviewing the Company's liquidity requirements and maximizing our net interest income consistent with capital requirements, liquidity, interest rate and economic outlooks, competitive factors and customer needs. One of the tools we use to determine our interest rate risk is gap analysis. Gap analysis attempts to examine the volume of interest rate sensitive assets less interest rate sensitive liabilities. The difference is the interest sensitivity gap, which indicates how future changes in interest rates may affect net interest income. Interest sensitivity gap analysis presents a position that existed at one particular point in time and assumes that assets and liabilities with similar characteristics will re-price at the same time and to the same degree. Regardless of whether interest rates are expected to increase or decrease, the objective is to maintain a gap position that will minimize any changes in net interest income. A negative gap exists when we have more interest sensitive liabilities maturing within a certain gap interval than interest sensitive assets. Under this scenario, if interest rates were to increase, it would tend to reduce interest income.

At December 31, 2002, we were liability sensitive in the 2-90 day, 91-180 day and 181-365 day gap intervals by 1.6%, 5.1% and 7.0%, respectively. This is within the Company's asset/liability management policy, which indicates that we maintain an interest rate sensitivity position +/-15% to total assets. We can reprice our interest checking, savings, and money market accounts at any time. Based on the degree and frequency of movement being limited in practice, we have classified 20% of these deposits in our immediate gap interval, 10% of these deposits through the 1-3 year gap interval, leaving the remaining portion or 40% of these deposits in the over 3 year gap interval.

We utilize a simulation modeling process to measure interest rate risk and the impact that rate fluctuations will have on net interest income. These simulations incorporate assumptions regarding balance sheet growth and mix, and

the re-pricing and maturity characteristics of existing and projected balance sheets. One of the ways we manage our interest rate risk is through an analysis of the relationship between interest-earnings assets and interest-bearing liabilities to measure the impact that future changes in interest rates will have on net interest income. Using this analysis, changes in interest rates and volumes are used to test the sensitivity of our net interest income. Simulation analysis uses a more dynamic version of the information shown in Tables 11 and 12, which reflects re-pricing or expected maturities of various assets and liabilities at December 31, 2002. While we show liability sensitivity in the short term indicating that an increase in interest rates may negatively affect short-term net interest income, we would likely take actions to minimize our exposure to negative results and within a short period of time make adjustments so that net interest income would not be materially impacted.

During 2002, our focus was to increase our deposit market share through promotion of our President's Club and Totally Free Checking products. The success of these promotions allowed us to grow total assets over 74.0%. Our President's Club relationship product allows customers with aggregate balances of over \$10,000 to earn an above market rate on their average balances, 2.00% as of December 31, 2002. Because of the success of this promotion, deposits grew more quickly than we could invest in higher yielding assets. As a result, our net interest margin declined throughout the year and averaged 2.92% for all of 2002. Our current focus is to improve our net interest margin by staying fully invested, minimizing lower yielding short-term investments and using our substantial mortgage-backed investment securities portfolio for backup liquidity needs.

Over time, net interest income will tend to be greater at higher interest rate levels. This is due to the large proportion of low-cost core deposits such as demand, interest checking, savings, and money market accounts comprising our funding sources, which can be invested in relatively higher yielding loans and investment securities.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

Table 11

### Interest Rate Sensitivity Gap Analysis

As of December 31, 2002

(Dollars in thousands)

|  | Immediate<br>Repricing | 2-90<br>Days      | 91-180<br>Days     | 181-365<br>Days    | 1-3<br>Years      | Over 3<br>Years   | TOTAL          |
|--|------------------------|-------------------|--------------------|--------------------|-------------------|-------------------|----------------|
| <b>Assets</b>  |                        |                   |                    |                    |                   |                   |                |
| Investment securities available-for-sale & other investments       | \$ —                   | \$ 2,163          | \$ 5,138           | \$ 8,450           | \$ 78,148         | \$ 71,381         | \$ 165,280     |
| Federal funds sold   | 35,906                 | —                 | —                  | —                  | —                 | —                 | 35,906         |
| <b>Loans Receivable</b>  |                        |                   |                    |                    |                   |                   |                |
| Commercial & industrial  | 41,005                 | 5,420             | 3,467              | 8,767              | 47,538            | 68,230            | 174,427        |
| Residential  | 109                    | 169               | 814                | 1,633              | 7,530             | 21,553            | 31,808         |
| Home equity lines  | 7,737                  | 18,465            | 313                | 316                | —                 | —                 | 26,831         |
| Construction   | 4,301                  | 14                | 6                  | 13                 | 84                | 1,363             | 5,781          |
| All other  | 1,044                  | 623               | 373                | 742                | 2,206             | 5,247             | 10,235         |
| <b>Total loans receivable</b>                                      | <b>54,196</b>          | <b>24,691</b>     | <b>4,973</b>       | <b>11,471</b>      | <b>57,358</b>     | <b>96,393</b>     | <b>249,082</b> |
| <b>Total earning assets</b>  | <b>90,102</b>          | <b>26,854</b>     | <b>10,111</b>      | <b>19,921</b>      | <b>135,506</b>    | <b>167,774</b>    | <b>450,268</b> |
| <b>Cumulative rate sensitive assets</b>                            | <b>\$ 90,102</b>       | <b>\$ 116,956</b> | <b>\$ 127,067</b>  | <b>\$ 146,988</b>  | <b>\$ 282,494</b> | <b>\$ 450,268</b> |                |
| <b>Liabilities</b>   |                        |                   |                    |                    |                   |                   |                |
| <b>Deposits</b>  |                        |                   |                    |                    |                   |                   |                |
| Noninterest-bearing demand   | \$ —                   | \$ —              | \$ —               | \$ —               | \$ —              | \$ 72,962         | \$ 72,962      |
| Interest-bearing transaction accounts                              | 35,384                 | 17,692            | 17,692             | 17,692             | 17,692            | 70,967            | 177,119        |
| Certificates of deposit – fixed                                    | —                      | 5,176             | 10,263             | 20,011             | 53,477            | 17,741            | 106,668        |
| Certificates of deposit – no penalty                               | —                      | 11,727            | 6,071              | 15,150             | 33,782            | —                 | 66,730         |
| <b>Total deposits</b>  | <b>35,384</b>          | <b>34,595</b>     | <b>34,026</b>      | <b>52,853</b>      | <b>104,951</b>    | <b>161,670</b>    | <b>423,479</b> |
| Other borrowed funds   | —                      | —                 | 1,000              | 1,000              | —                 | —                 | 2,000          |
| <b>Total deposits &amp; other borrowed funds</b>                   | <b>35,384</b>          | <b>34,595</b>     | <b>35,026</b>      | <b>53,853</b>      | <b>104,951</b>    | <b>161,670</b>    | <b>425,479</b> |
| <b>Cumulative rate sensitive liabilities</b>                       | <b>\$ 35,384</b>       | <b>\$ 69,979</b>  | <b>\$ 105,005</b>  | <b>\$ 158,858</b>  | <b>\$ 263,809</b> | <b>\$ 425,479</b> |                |
| <b>Gap</b>   | <b>\$ 54,718</b>       | <b>\$ (7,741)</b> | <b>\$ (24,915)</b> | <b>\$ (33,932)</b> | <b>\$ 30,555</b>  | <b>\$ 6,104</b>   |                |
| <b>Cumulative gap</b>  | <b>54,718</b>          | <b>46,977</b>     | <b>22,062</b>      | <b>(11,870)</b>    | <b>18,685</b>     | <b>24,789</b>     |                |
| <b>Gap/total assets</b>  | <b>11.25%</b>          | <b>-1.59%</b>     | <b>-5.12%</b>      | <b>-6.98%</b>      | <b>6.28%</b>      | <b>1.26%</b>      |                |
| <b>Cumulative gap/total assets</b>                                 | <b>11.25%</b>          | <b>9.66%</b>      | <b>4.54%</b>       | <b>-2.44%</b>      | <b>3.84%</b>      | <b>5.10%</b>      |                |
| <b>Rate sensitive assets/rate sensitive liabilities</b>            | <b>2.55x</b>           | <b>0.78x</b>      | <b>0.29x</b>       | <b>0.37x</b>       | <b>1.29x</b>      | <b>1.04x</b>      |                |
| <b>Cumulative rate sensitive assets/rate sensitive liabilities</b> | <b>2.55x</b>           | <b>1.67x</b>      | <b>1.21x</b>       | <b>0.93x</b>       | <b>1.07x</b>      | <b>1.06x</b>      |                |
| <b>Rate shock at +2.00%</b>  | <b>\$ 1,091</b>        | <b>\$ (154)</b>   | <b>\$ (497)</b>    | <b>\$ (677)</b>    |                   |                   |                |
| <b>Net interest income at risk by period</b>                       | <b>10.24%</b>          | <b>-1.45%</b>     | <b>-4.66%</b>      | <b>-6.35%</b>      |                   |                   |                |
| <b>Annualized net interest income</b>                              | <b>\$ 10,656</b>       |                   |                    |                    |                   |                   |                |
| <b>Net interest income at risk for one year period</b>             | <b>-2.22%</b>          |                   |                    |                    |                   |                   |                |
| <b>Rate shock at -2.00%</b>  | <b>\$ (1,091)</b>      | <b>\$ 154</b>     | <b>\$ 497</b>      | <b>\$ 677</b>      |                   |                   |                |
| <b>Net interest income at risk by period</b>                       | <b>-10.24%</b>         | <b>1.45%</b>      | <b>4.66%</b>       | <b>6.35%</b>       |                   |                   |                |
| <b>Annualized net interest income</b>                              | <b>\$ 10,656</b>       |                   |                    |                    |                   |                   |                |
| <b>Net interest income at risk for one year period</b>             | <b>2.22%</b>           |                   |                    |                    |                   |                   |                |

## Management's Discussion and Analysis of Financial Condition and Results of Operations

**Table 12**

**Loan Maturities and Interest Rate Sensitivity**  
As of December 31, 2002  
(Dollars in thousands)

|                         | One Year<br>or Less | Between One<br>and Five Years | After<br>Five Years | Total      |
|-------------------------|---------------------|-------------------------------|---------------------|------------|
| Commercial & industrial | \$ 58,659           | \$ 73,875                     | \$ 41,893           | \$ 174,427 |
| Residential             | 2,725               | 20,623                        | 8,460               | 31,808     |
| Home equity lines       | 26,831              | —                             | —                   | 26,831     |
| Construction            | 4,334               | 1,447                         | —                   | 5,781      |
| All other               | 2,782               | 3,741                         | 3,712               | 10,235     |
| Total loans receivable  | \$ 95,331           | \$ 99,686                     | \$ 54,065           | \$ 249,082 |
| Fixed — rate loans      |                     | \$ 9,689                      | \$ 5,123            | \$ 14,812  |
| Floating — rate loans   |                     | 89,997                        | 48,942              | 138,939    |
| Total loans receivable  |                     | \$ 99,686                     | \$ 54,065           | \$ 153,751 |

### Business Segment Operations

We provide banking and non-banking financial services and products through our subsidiaries. Management operates and reports on the results of our operations through two business segments, banking and investment advisory services.

#### Banking

The banking segment provides comprehensive banking services to small businesses and individuals through multiple delivery channels. Services offered include commercial and consumer lending, deposit products, and banking via the internet or telephone.

For the year ended December 31, 2002, the banking segment recorded a net loss of \$16,000, compared to a recorded net loss of \$10.2 million for the year ended December 31, 2001. The decrease in the net loss for 2002 is a result of increased earning assets and lower operating expenses. The results for 2001 included both the amortization and impairment recognition in goodwill. Net interest income, as our primary source of revenue, for the years ended December 31, 2002, 2001, and 2000 were \$10.6 million, \$9.1 million and \$5.9 million, respectively.

As of December 31, 2002 and 2001, total assets were \$483.1 million and \$277.9 million, respectively. Loans receivable, net as of December 31, 2002 and 2001 were \$245.7 million and \$197.8 million, respectively. Total deposits as of December 31, 2002 and 2001 were \$423.5 million and \$246.0 million, respectively.

#### Investment Advisory Services

The investment advisory services segment offers financial and estate planning services, centered on a group of products provided through a strategic alliance with Legg Mason Financial Partners, a wholly owned subsidiary of Legg Mason, Inc. Operations for this segment began February 1, 1999.

For the years ended December 31, 2002, 2001 and 2000, the investment advisory services segment reported net losses of \$205,000, \$87,000 and \$475,000, respectively. Investment fee income, as the primary source of revenue for this reporting segment, for the years ended December 31, 2002, 2001 and 2000 were \$940,000, \$1.9 million and \$1.5 million, respectively. Investment fee income decreased during 2002 as compared to prior periods as a result of reduced transaction activity and decreased assets under management experienced during 2002.

As of December 31, 2002 and 2001, total assets were \$274,000 and \$420,000, respectively. Total assets under management were \$98.8 million and \$102.2 million as of December 31, 2002 and 2001, respectively.

Information pertaining to both business segments can be found in Footnote 15 to the Notes to Consolidated Financial Statements.

#### Quarterly Data

We recorded net income of \$85,000 or \$0.01 per common share for the fourth quarter of 2002, our second consecutive profitable quarter for 2002, as compared to a \$2.48 loss per common share for the same period of 2001. Table 13 reflects quarterly data for the years ended December 31, 2002 and 2001.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

Table 13

Quarterly Data

Years ended December 31, 2002 and 2001

(Dollars in thousands, except per share data)

| 2002  |                   |                  |                   |                  |
|---|-------------------|------------------|-------------------|------------------|
|   | Fourth<br>Quarter | Third<br>Quarter | Second<br>Quarter | First<br>Quarter |
| Interest income                                     | \$ 5,325          | \$ 5,484         | \$ 5,039          | \$ 4,394         |
| Interest expense                                    | 2,544             | 2,643            | 2,379             | 2,020            |
| Net interest income                                 | 2,781             | 2,841            | 2,660             | 2,374            |
| Provision for loan losses                           | (310)             | (95)             | (39)              | —                |
| Net interest income after provision for loan losses | 2,471             | 2,746            | 2,621             | 2,374            |
| Non-interest income                                 | 1,107             | 728              | 642               | 796              |
| Non-interest expense                                | 3,370             | 3,045            | 4,491             | 3,108            |
| Net income (loss) before income taxes               | 208               | 429              | (1,228)           | 62               |
| Provision for income taxes                          | —                 | —                | —                 | —                |
| Net income (loss)                                   | \$ 208            | \$ 429           | \$ (1,228)        | \$ 62            |
| Dividends to preferred shareholders                 | 123               | 124              | 124               | 124              |
| Net income (loss) to common shareholders            | \$ 85             | \$ 305           | \$ (1,352)        | \$ (62)          |
| Basic and diluted income (loss) per common share    | \$ 0.01           | \$ 0.03          | \$ (0.18)         | \$ (0.01)        |

| 2001  |                   |                  |                   |                  |
|---|-------------------|------------------|-------------------|------------------|
|   | Fourth<br>Quarter | Third<br>Quarter | Second<br>Quarter | First<br>Quarter |
| Interest income                                     | \$ 4,226          | \$ 4,213         | \$ 4,167          | \$ 3,971         |
| Interest expense                                    | 1,797             | 1,824            | 1,973             | 1,906            |
| Net interest income                                 | 2,429             | 2,389            | 2,194             | 2,065            |
| Provision for loan losses                           | (826)             | (190)            | (129)             | (57)             |
| Net interest income after provision for loan losses | 1,603             | 2,199            | 2,065             | 2,008            |
| Non-interest income                                 | 791               | 854              | 970               | 652              |
| Non-interest expense                                | 12,844            | 3,759            | 3,700             | 3,563            |
| Net loss before income taxes                        | (10,450)          | (706)            | (665)             | (903)            |
| Provision for income taxes                          | —                 | —                | —                 | —                |
| Net loss  | \$ (10,450)       | \$ (706)         | \$ (665)          | \$ (903)         |
| Dividends to preferred shareholders                 | 119               | 128              | 128               | 128              |
| Net loss to common shareholders                     | \$ (10,569)       | \$ (834)         | \$ (793)          | \$ (1,031)       |
| Basic and diluted loss per common share             | \$ (2.48)         | \$ (0.20)        | \$ (0.19)         | \$ (0.24)        |



## Management's Discussion and Analysis of Financial Condition and Results of Operations

### 2001 Compared to 2000

#### Earnings Overview

In the fourth quarter of 2001 our net loss was \$10.6 million, which included an impairment of \$8.3 million that effectively eliminated the goodwill associated with our merger with Heritage Bancorp, Inc. An evaluation of 2001 losses produced by Cardinal Bank – Potomac and expectations of future additional losses indicated a potential impairment in our investment in Heritage. Loan and deposit growths were materially less than what had been anticipated in our original projections. The amount of the impairment was determined through an independent appraisal of the remaining assets and liabilities of Heritage Bancorp, Inc. performed during the fourth quarter of 2001. In addition, management refined its loan loss reserve methodology, which resulted in an additional provision to our loan loss reserve of \$774,000. Additional costs relating to our restructuring totaled \$829,000 during the last quarter of 2001.

Our net loss for the year ended December 31, 2001 totaled \$13.2 million or (\$3.11) per common share, compared with a loss of \$4.1 million or (\$0.98) per common share for the same period of 2000. The 2001 loss included an impairment of \$8.3 million that substantially eliminated the goodwill attributed to the purchase of Heritage Bancorp, Inc. The return on average assets was (5.24%) in 2001 as compared to (2.72%) in 2000. The return on average equity was (39.14%) in 2001 as compared to (12.72%) in 2000. Earnings per common share reflect the payment of preferred dividends of \$503,000 and \$171,000 for the years ended December 31, 2001 and 2000, respectively. Excluding the preferred dividends and the write down of goodwill, the loss for the year ended December 31, 2001 was \$4.5 million as compared to \$4.1 million for the same period of 2000. Table 1 shows a reconciliation of GAAP to Non-GAAP Financial Measures.

Total earning assets increased by 40.9% to \$264.1 million at December 31, 2001 as compared to \$187.3 million at December 31, 2000. This increase consisted mainly of \$46.6 million or 30.2% growth in total loans, net of fees and a \$27.2 million increase in investment securities available-for-sale. These increases were primarily funded by total deposit growth of \$82.7 million or 50.6% over December 31, 2000 balances.

Operating results in 2001 reflected significant increases in all income and expense categories due to our growth. We purchased Heritage Bancorp, Inc. and its sole operating subsidiary, The Heritage Bank, on September 1, 2000, which contributed a full year of operating income and expenses in 2001 as compared to four months in 2000.

Net interest income was \$9.1 million in 2001, up \$2.7 million from 2000 or 41.6%. This increase was substantially due to increased volume as the net interest margin had decreased. The net interest margin was 4.17% for the year ended December 31, 2001 as compared to 4.82% for the same period of 2000. The drop in interest rates by 475 basis points during 2001 contributed to this decline as our earning assets have repriced sooner than interest-bearing liabilities. Average total loans increased \$77.0 million to \$181.0 million in 2001 from \$104.0 million in 2000, due to strong loan demand. Average total deposits increased \$91.5 million to \$197.4 million in 2001 from \$105.9 million in 2000.

In 2001, the loan loss provision of \$1.2 million was \$449,000 greater than the \$753,000 recorded in 2000 due partially to the increase in loan balances, both originated and acquired during 2001. Of the \$1.2 million increase in loan loss reserves in 2001, \$644,000 was due to increases in loan balances, \$157,000 was due to an increase in reserves specifically allocated to one non-performing credit, and \$399,000 was due to refinements in our loan loss methodology.

Non-interest income was \$3.3 million in 2001, a 55.7% increase compared to 2000. The largest portion of this increase was investment fee income from our subsidiary, Cardinal Wealth Services, Inc., which increased to \$1.9 million in 2001 from \$1.5 million in 2000. Service charges on deposit accounts increased \$244,000 to \$398,000 during 2001 due to increased deposit accounts.

Non-interest expense was \$23.9 million in 2001 compared to \$11.7 million in 2000. The 2001 increase included an impairment of \$8.3 million that substantially eliminated the goodwill attributed to the purchase of Heritage Bancorp, Inc. Additional expenses of approximately \$884,000 in nonrecurring costs associated with a corporate restructuring were included in 2001.

#### Net Interest Income/Margin

The net interest margin was 4.17% for the year ended December 31, 2001 as compared to 4.82% for the same period of 2000. The Federal Open Market Committee decreased interest rates by 475 basis points during 2001 contributing to a decline in the net interest margin as earning assets have repriced sooner than interest-bearing liabilities. The rate on interest earning assets decreased to 7.61% in 2001 from 8.39% in 2000 and our cost of funds decreased to 3.13% in 2001 from 3.29% in 2000. Average total loans increased \$77.0 million to \$181.0 million in 2001 from \$104.0 million in 2000, due to strong loan demand primarily in commercial loans and commercial real estate loans. Average balances for nonperforming assets are included in the net interest margin calculation and did not have a material impact on our net interest margin in 2001 and 2000. Additional interest income of approximately \$17,000 for 2001 and \$34,000 for 2000 would have been realized had all nonperforming assets performed as originally expected. Nonperforming assets exclude loans that are both past due 90 days or more and not deemed nonaccrual, due to an assessment of collectibility. Nonperforming assets consist of nonaccrual loans. Average total deposits increased \$91.5 million to \$197.4 million in 2001 from \$105.9 million in 2000. Although all deposit accounts grew, the largest increase was in average certificates of deposit.

Tables 2 and 3 contain more detailed information concerning average balances, yields earned, and rates paid.

#### Provision and Allowance for Loan Losses

The loan loss provision was \$1.2 million in 2001 as compared to \$753,000 in 2000 due partially to the increase in loan balances, both originated and acquired during 2001. In addition to the increased loan balances, we refined our loan loss reserve methodology during the fourth quarter of 2001, which, together with the growth in loan balances experienced during the fourth quarter, resulted in an additional provision of \$774,000. A specific reserve of \$157,000 was recorded within the allowance for loan losses to reflect the non-performing status of one credit in our loan portfolio.

The allowance for loan losses increased to \$3.1 million in 2001 from \$1.9 million in 2000. The ratio of the allowance for loan losses to gross loans at December 31, 2001 was 1.54% compared to 1.23% at December 31, 2000. Of the \$1.2 million increase in loan loss reserves in 2001, \$644,000 was due to increases in loan balances, \$157,000 was due to an increase in reserves specifically allocated to one non-performing credit, and \$399,000 was due to refinements in our loan loss reserve methodology.

From our inception through December 31, 2001, we had not experienced any loan losses, due primarily to the lack of maturity of our loan portfolio. Under normal circumstances, we would base the level of our loan loss reserves on actual loss experience. In the absence of a history of actual loss experience, we had used peer group loss factors, adjusted by certain qualitative factors, including levels of and trends in delinquencies and nonaccrual loans, national and local economic trends and conditions, and concentrations of loans exhibiting similar risk profiles.

During the fourth quarter of 2001, we refined our loan loss analysis in three ways:

- We updated our comparative peer group to commercial banks located in Virginia, the District of Columbia and Maryland with total assets of \$250 million to \$500 million to better reflect the anticipated consolidation of all banking subsidiaries into one. Prior to the fourth quarter of 2001, peer group averages had been based on the Uniform Bank Performance Report for all commercial banks with assets of less than \$100 million and was consistent with our prior structure of four separately chartered banks.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

- We adjusted peer group loss averages by a "duration" factor beginning in the fourth quarter of 2001, which had previously not been included in our analysis.
- We elevated the importance of qualitative factors in our analysis, due primarily to declining economic conditions and an increase in our concentration in commercial real estate loans from 36% of the total loan portfolio as of December 31, 2000 to 43% as of December 31, 2001. Under the revised analysis, qualitative adjustments to loss factors ranged from 40 basis points on residential mortgages to 95 basis points on commercial real estate loans. Under the methodology used prior to the fourth quarter of 2001, qualitative adjustments had resulted in adjusting factors ranging from zero to fifty basis points.

Tables 4 and 5 contain additional information pertaining to the calculation and allocation of the allowance for loan losses by loan type and the percentage of the loan type to the total loan portfolio.

### *Loans Receivable*

Total loans, net of fees and premiums and discounts, increased \$46.6 million to \$200.9 million at December 31, 2001. The strongest growth was in commercial loans and commercial real estate loans reflecting our strength as a local small business community bank.

Our loan portfolio has a heavy commercial orientation as evidenced by the information provided in Table 8. We began in late 1999 to better diversify the loan portfolio by purchasing consumer loans. We continued to diversify our portfolio in 2000 and 2001 by purchasing consumer installment loans.

Loans receivable accounted for on a non-accrual basis at December 31, 2001 and 2000 were \$361,000 and \$585,000, respectively. Accruing loans, which are contractually past due 90 days or more as to principal or interest payments as of December 31, 2001 and 2000, were \$566,000 and \$2,000, respectively. There are no loans as of December 31, 2001 and 2000 included above which are "troubled debt restructurings." Specific reserves of \$157,000 were made in 2001 for one of the non-accrual loans. At December 31, 2001 the ratio of non-performing loans to total loans was 0.18% as compared to 0.38% at December 31, 2000. Table 9 presents additional information on nonperforming loans receivable.

### *Non-Interest Income*

Non-interest income was \$3.3 million for the year ended December 31, 2001, an increase of \$1.2 million over the same period of 2000. The largest portion of this increase was investment fee income from our subsidiary Cardinal Wealth Services, Inc., which increased to \$1.9 million in 2001 from \$1.5 million in 2000. Due to increased deposit accounts, service charges on deposit accounts increased \$244,000 to \$398,000 during 2001 as compared to \$154,000 in 2000. Loan service charges increased to \$433,000 or 88.3% from \$230,000 in 2000 due to the increase in the loan portfolio. During 2001, we consolidated operations, sublet the excess space and received rental income of \$110,000 for that space. Table 6 provides additional detail on non-interest income for the years ended December 31, 2002, 2001 and 2000.

### *Non-Interest Expense*

Non-interest expense was \$23.9 million and \$11.7 million for the years ended December 31, 2001 and 2000, respectively. The 2001 increase included a one-time charge of \$8.3 million that substantially eliminated the goodwill attributed to the purchase of Heritage Bancorp, Inc. An evaluation of 2001 year losses produced by Cardinal Bank - Potomac and expectations of future additional losses indicated a potential impairment in our investment in Heritage. Loan and deposit growths were materially less than what had been anticipated in our original projections. Projections were based on historical growth under prior management and the experience of the Heritage lending group. At September 30, 2001, total loans and deposits were \$29.0 million

and \$22.0 million less than what we had projected. This differential between actual and projected growth was partially due to the loss of customer generating employees and the subsequent loss of their respective portfolios. In the fourth quarter of 2001, a valuation of Cardinal Bank - Potomac was performed by an external consultant in response to these impairment indicators. The valuation was performed in compliance with SFAS No. 121 and indicated a significant impairment, which resulted in the write down of goodwill of \$8.3 million. Also, during 2001, we made the decision to restructure from four banks to one to simplify our structure and reduce costs. Consequently, included in non-interest expense is approximately \$884,000 in non-recurring costs associated with the restructuring. This restructuring was completed in the first quarter of 2002. In addition, operating results in 2001 and 2000 reflected significant increases in all income and expense categories due to our growth. Table 7 reflects the components of non-interest expense for the years ended December 31, 2002, 2001 and 2000.

### *Investment Securities Available-for-Sale*

Investment securities increased to \$34.1 million at December 31, 2001 as compared to \$6.9 million at December 31, 2000. Our growth and simplification of our structure have made more funds available for investments. The portfolio yield decreased from 6.60% as of December 31, 2000 to 5.36% as of December 31, 2001 due to higher yielding investments maturing or being called. Table 10 reflects the composition of the investment portfolio as of December 10, 2002, 2001 and 2000.

### *Capital Resources*

Capital adequacy is an important measure of financial stability and performance. Our objectives are to maintain a level of capitalization that is sufficient to sustain asset growth and promote depositor and investor confidence.

Regulatory agencies measure capital adequacy utilizing a formula that takes into account the individual risk profile of financial institutions. The guidelines define capital as both Tier 1 (primarily common shareholders' equity, defined to include certain debt obligations) and Tier 2 (to include certain other debt obligations and a portion of the allowance for loan losses and 45% of unrealized gains in equity securities).

At December 31, 2002, shareholders' equity was \$40.7 million compared to \$20.6 million at December 31, 2001. The increase in shareholders' equity is the result of our successful second quarter 2002 rights and secondary common stock offerings, which raised \$18.5 million in new capital. In addition, changes in unrealized gains on investment securities available-for-sale amounted to \$2.6 million for the year ended December 31, 2002. The increases in common stock and other comprehensive income offset the preferred dividends paid and the net loss for 2002. Book value per common share as December 31, 2002 and 2001 was \$3.37 and \$3.21, respectively.

Footnote 10 to the Notes to Consolidated Financial Statements shows the minimum capital requirement and our capital position as of December 31, 2002 and 2001 for the bank holding company. Our regulatory capital levels for the bank and bank holding company meet those established for well-capitalized institutions.

We expect to invest funds in the previously announced relocation of our headquarters to Tysons Corner, Virginia and branch acquisitions. However, the lease on our current headquarters space expires in 2004, and during the past year we have had success in subleasing other excess or vacated space. Moreover, the branches to be acquired are currently being used as bank branches and can be converted to our use on a turnkey basis. We are not acquiring (or paying for) deposits, and the branch acquisitions are spread over 2003 and 2004.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

### Liquidity

The objective of liquidity management is to ensure the continuous availability of funds to meet the demands of depositors, investors and borrowers. Stable core deposits and a strong capital position are the current components of a solid foundation for our liquidity position. In addition, the availability of regional and national wholesale funding sources including federal funds purchased, negotiable certificates of deposit, securities sold under agreements to repurchase, and borrowings from the Federal Home Loan Bank enhance our liquidity. Cash flows from operations, such as loan payments and payoffs are also a significant source of liquidity. We have a contingency plan that provides for continued monitoring of liquidity needs and available sources of liquidity. We believe we have the ability to meet our liquidity needs. Liquid assets, which include cash and due from banks, federal funds sold and investment securities available-for-sale, at December 31, 2002, totaled \$227.0 million. Of that, \$131.7 million in investment securities available-for-sale were available as collateral for additional Federal Home Loan Bank borrowings. Table 14 reflects the maturities of the certificates of deposit of \$100,000 or more as of December 31, 2002.

Table 14

### Certificates of Deposit of \$100,000 or More

As of December 31, 2002

(Dollars in thousands)

|                                       |                  |
|---------------------------------------|------------------|
| Maturities:                           |                  |
| Three months or less                  | \$ 10,759        |
| Over three months through six months  | 8,716            |
| Over six months through twelve months | 15,323           |
| Over twelve months                    | 45,214           |
|                                       | <u>\$ 80,012</u> |

### Forward-Looking Statements

This Annual Report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are not historical facts, but rather are predictions and generally can be identified by use of statements that include phrases such as "believe," "expect," "anticipate," "estimate," "intend," "plan," "foresee" or other words or phrases of similar import. Similarly, statements that describe our future financial condition or results of operations, objectives, strategies, plans, goals or future performance and business also are forward-looking statements. These forward-looking statements involve known and unknown risks, uncertainties and other factors, including those described in our Annual Report on Form 10-K, that could cause our actual results to differ materially from those currently anticipated in these forward-looking statements. In light of these risks and uncertainties, the forward-looking events might or might not occur.

## Independent Auditors' Report

The Board of Directors and Shareholders  
Cardinal Financial Corporation and subsidiaries:

We have audited the accompanying consolidated statements of condition of Cardinal Financial Corporation and subsidiaries (the Company) as of December 31, 2002 and 2001, and the related consolidated statements of operations, comprehensive income (loss), changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2002. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Cardinal Financial Corporation and subsidiaries as of December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

**KPMG LLP**

McLean, Virginia  
January 15, 2003

## Consolidated Statements of Condition

| As of December 31   | 2002       | 2001       |
|---|------------|------------|
| <i>(Dollars in thousands, except share data)</i>  |            |            |
| <b>Assets</b>   |            |            |
| Cash and due from banks   | \$ 27,465  | \$ 11,446  |
| Federal funds sold  | 35,906     | 23,013     |
| Total cash and cash equivalents   | 63,371     | 34,459     |
| Investment securities available-for-sale  | 163,665    | 34,147     |
| Other investments   | 1,615      | 1,268      |
| Loans held for sale   | —          | 4,732      |
| Loans receivable, net of fees   | 249,106    | 200,911    |
| Allowance for loan losses   | (3,372)    | (3,104)    |
| Loans receivable, net   | 245,734    | 197,807    |
| Premises and equipment, net   | 4,942      | 5,077      |
| Goodwill and other intangibles, net   | 646        | 668        |
| Accrued interest and other assets   | 6,350      | 1,426      |
| Total assets  | \$ 486,323 | \$ 279,584 |
| <b>Liabilities and Shareholders' Equity</b>   |            |            |
| Deposits  | \$ 423,479 | \$ 246,024 |
| Other borrowed funds  | 2,000      | 9,824      |
| Accrued interest and other liabilities  | 20,132     | 3,112      |
| Total liabilities   | 445,611    | 258,960    |
| Preferred stock, \$1 par value, 10,000,000 shares authorized:   |            |            |
| Series A preferred stock, cumulative convertible, 1,364,684 and 1,364,714 shares outstanding in 2002 and 2001, respectively           | 1,365      | 1,365      |
| Common stock, \$1 par value, 50,000,000 shares authorized, 10,044,345 and 4,294,323 shares outstanding in 2002 and 2001, respectively | 10,044     | 4,294      |
| Additional paid-in capital  | 51,231     | 38,488     |
| Accumulated deficit   | (24,273)   | (23,249)   |
| Accumulated other comprehensive income (loss)   | 2,345      | (274)      |
| Total shareholders' equity  | 40,712     | 20,624     |
| Total liabilities and shareholders' equity  | \$ 486,323 | \$ 279,584 |

See accompanying notes to consolidated financial statements.

# Consolidated Statements of Operations

| Years ended December 31  | 2002       | 2001        | 2000       |
|--|------------|-------------|------------|
| <i>(In thousands, except per share data)</i>                         |            |             |            |
| Interest income:   |            |             |            |
| Loans receivable   | \$ 14,798  | \$ 14,973   | \$ 9,258   |
| Federal funds sold   | 871        | 1,085       | 1,451      |
| Investment securities available-for-sale                             | 4,501      | 437         | 371        |
| Other investments  | 72         | 82          | 70         |
| Total interest income  | 20,242     | 16,577      | 11,150     |
| Interest expense:  |            |             |            |
| Deposits   | 9,364      | 7,027       | 4,293      |
| Other borrowed funds   | 222        | 473         | 447        |
| Total interest expense   | 9,586      | 7,500       | 4,740      |
| Net interest income  | 10,656     | 9,077       | 6,410      |
| Provision for loan losses  | 444        | 1,202       | 753        |
| Net interest income after provision for loan losses                  | 10,212     | 7,875       | 5,657      |
| Non-interest income:   |            |             |            |
| Service charges on deposit accounts                                  | 511        | 398         | 154        |
| Loan service charges   | 392        | 433         | 230        |
| Investment fee income  | 940        | 1,941       | 1,516      |
| Net gain (loss) on sales of loans                                    | 74         | 49          | (23)       |
| Net realized gain (loss) on investment securities available-for-sale | 524        | —           | (32)       |
| Net gain on sales of assets  | 39         | 18          | 57         |
| Other income   | 793        | 428         | 196        |
| Total non-interest income  | 3,273      | 3,267       | 2,098      |
| Non-interest expense:  |            |             |            |
| Salary and benefits  | 5,715      | 7,731       | 6,317      |
| Occupancy  | 1,381      | 1,373       | 1,075      |
| Professional fees  | 1,011      | 705         | 508        |
| Depreciation   | 736        | 804         | 601        |
| Writedown on WorldCom bond   | 1,660      | —           | —          |
| Amortization and write down of intangibles                           | 22         | 8,907       | 235        |
| Other operating expenses   | 3,489      | 4,346       | 2,990      |
| Total non-interest expense   | 14,014     | 23,866      | 11,726     |
| Net loss before income taxes   | (529)      | (12,724)    | (3,971)    |
| Provision for income taxes   | —          | —           | —          |
| Net loss   | \$ (529)   | \$ (12,724) | \$ (3,971) |
| Dividends to preferred shareholders                                  | 495        | 503         | 171        |
| Net loss to common shareholders                                      | \$ (1,024) | \$ (13,227) | \$ (4,142) |
| Basic and diluted loss per common share                              | \$ (0.13)  | \$ (3.11)   | \$ (0.98)  |
| Weighted-average common shares outstanding                           | 7,949      | 4,258       | 4,246      |

See accompanying notes to consolidated financial statements.

## Consolidated Statements of Comprehensive Income (Loss)

| Years ended December 31   | 2002     | 2001        | 2000       |
|---|----------|-------------|------------|
| <i>(Dollars in thousands)</i>   |          |             |            |
| Net loss  | \$ (529) | \$ (12,724) | \$ (3,971) |
| Other comprehensive income (loss):  |          |             |            |
| Unrealized gain (loss) on available-for-sale investment securities:       |          |             |            |
| Unrealized holding gain (loss) arising during the year                    | 3,143    | (278)       | 85         |
| Less: reclassification adjustment for gains (losses) included in net loss | 524      | —           | (32)       |
| Comprehensive income (loss)   | \$ 2,090 | \$ (13,002) | \$ (3,854) |

See accompanying notes to consolidated financial statements.

## Consolidated Statements of Changes in Shareholders' Equity

| Years ended December 31, 2002, 2001 and 2000                                 | Preferred Shares | Preferred Stock | Common Shares | Common Stock | Paid-in Capital | Additional Accumulated Deficit | Accumulated Other Comprehensive Income (Loss) | Total     |
|--|------------------|-----------------|---------------|--------------|-----------------|--------------------------------|---|-----------|
| <i>(Dollars in thousands)</i>  |                  |                 |               |              |                 |                                |   |           |
| Balance, December 31, 1999   | —                | \$ —            | 4,243         | \$ 4,243     | \$ 32,496       | \$ (5,881)                     | \$ (113)                                      | \$ 30,745 |
| Issuance of 1,411,499 shares of cumulative preferred stock, par value \$1    | 1,411            | 1,411           | —             | —            | 5,645           | —                              | —   | 7,056     |
| Issuance of common stock options in connection with acquisition              | —                | —               | —             | —            | 301             | —                              | —   | 301       |
| Stock options exercised  | —                | —               | 7             | 7            | 15              | —                              | —   | 22        |
| Issuance of stock awards   | —                | —               | 3             | 3            | 9               | —                              | —   | 12        |
| Dividends on preferred stock   | —                | —               | —             | —            | —               | (170)                          | —   | (170)     |
| Change in unrealized gain (loss) on investment securities available-for-sale | —                | —               | —             | —            | —               | —                              | 117   | 117       |
| Net loss   | —                | —               | —             | —            | —               | (3,971)                        | —   | (3,971)   |
| Balance, December 31, 2000   | 1,411            | \$ 1,411        | 4,253         | \$ 4,253     | \$ 38,466       | \$ (10,022)                    | \$ 4  | \$ 34,112 |
| Issuance of stock awards   | —                | —               | 3             | 3            | 3               | —                              | —   | 6         |
| Stock options exercised  | —                | —               | 3             | 3            | 8               | —                              | —   | 11        |
| Dividends on preferred stock   | —                | —               | —             | —            | —               | (503)                          | —   | (503)     |
| Preferred stock converted to common stock                                    | (46)             | (46)            | 35            | 35           | 11              | —                              | —   | —         |
| Change in unrealized gain (loss) on investment securities available-for-sale | —                | —               | —             | —            | —               | —                              | (278)   | (278)     |
| Net loss   | —                | —               | —             | —            | —               | (12,724)                       | —   | (12,724)  |
| Balance, December 31, 2001   | 1,365            | \$ 1,365        | 4,294         | \$ 4,294     | \$ 38,488       | \$ (23,249)                    | \$ (274)                                      | \$ 20,624 |
| Rights offering shares issued  | —                | —               | 2,437         | 2,437        | 5,462           | —                              | —   | 7,899     |
| Public offering shares issued  | —                | —               | 3,313         | 3,313        | 7,281           | —                              | —   | 10,594    |
| Dividends on preferred stock   | —                | —               | —             | —            | —               | (495)                          | —   | (495)     |
| Change in unrealized gain (loss) on investment securities available-for-sale | —                | —               | —             | —            | —               | —                              | 2,619   | 2,619     |
| Net loss   | —                | —               | —             | —            | —               | (529)                          | —   | (529)     |
| Balance, December 31, 2002   | 1,365            | \$ 1,365        | 10,044        | \$ 10,044    | \$ 51,231       | \$ (24,273)                    | \$ 2,345                                      | \$ 40,712 |

See accompanying notes to consolidated financial statements.

## Consolidated Statements of Cash Flows

| Years Ended December 31  | 2002      | 2001        | 2000       |
|--|-----------|-------------|------------|
| <i>(Dollars in thousands, except share data)</i>   |           |             |            |
| Cash flows from operating activities:  |           |             |            |
| Net loss   | \$ (529)  | \$ (12,724) | \$ (3,971) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities:  |           |             |            |
| Depreciation   | 736       | 804         | 600        |
| Amortization and writedown of intangibles, premiums and discounts  | 1,120     | 8,960       | 230        |
| Provision for loan losses  | 444       | 1,202       | 753        |
| Originations of loans held for sale  | (4,369)   | (15,807)    | 1,275      |
| Proceeds from the sale of loans held for sale  | 9,175     | 11,124      | (1,252)    |
| Writedown on WorldCom bond   | 1,660     | —           | —          |
| (Gain) loss on sale of investment securities available-for-sale  | (524)     | —           | 32         |
| Gain on sale of other assets   | (113)     | (67)        | (48)       |
| (Increase) decrease in accrued interest and other assets   | (4,924)   | 117         | (1,082)    |
| Increase in accrued interest and other liabilities   | 17,020    | 834         | 1,268      |
| Compensation related to stock awards   | —         | 6           | 12         |
| Net cash provided by (used in) operating activities  | 19,696    | (5,551)     | (2,183)    |
| Cash flows from investing activities:  |           |             |            |
| Purchase of premises and equipment   | (601)     | (501)       | (1,456)    |
| Proceeds from sale of premises and equipment   | —         | 28          | 175        |
| Proceeds from sale, maturity and call of investment securities available-for-sale  | 42,034    | 4,500       | 2,468      |
| Proceeds from sale of other investments  | 188       | 832         | —          |
| Purchase of investment securities available-for-sale   | (197,255) | (34,101)    | —          |
| Purchase of other investments  | (535)     | (587)       | (133)      |
| Redemptions of investment securities available-for-sale  | 25,564    | 2,111       | 421        |
| Net increase in loans receivable   | (47,808)  | (46,458)    | (48,244)   |
| Net cash acquired in acquisition   | —         | —           | 11,090     |
| Net cash used in investing activities  | (178,413) | (74,176)    | (35,679)   |
| Cash flows from financing activities:  |           |             |            |
| Net increase in deposits   | 177,455   | 82,653      | 49,600     |
| Net increase (decrease) in other borrowed funds  | (7,824)   | 2,537       | (1,145)    |
| Proceeds from rights offering  | 7,899     | —           | —          |
| Proceeds from public offering  | 10,594    | —           | —          |
| Dividends on preferred stock   | (495)     | (503)       | (170)      |
| Stock options exercised  | —         | 11          | 22         |
| Net cash provided by financing activities  | 187,629   | 84,698      | 48,307     |
| Net increase in cash and cash equivalents  | 28,912    | 4,971       | 10,445     |
| Cash and cash equivalents at beginning of year   | 34,459    | 29,488      | 19,043     |
| Cash and cash equivalents at end of year   | \$ 63,371 | \$ 34,459   | \$ 29,488  |
| Supplemental disclosure of cash flow information:  |           |             |            |
| Cash paid during year for interest   | \$ 9,491  | \$ 7,538    | \$ 4,676   |
| Supplemental schedule of noncash investing and financing activities:   |           |             |            |
| In 2000, the Company purchased all of the common stock of Heritage Bancorp, Inc. for \$14.4 million. In conjunction with the acquisition, liabilities were assumed as follows: |           |             |            |
| Fair value of assets acquired  |           |             | \$ 62,162  |
| Goodwill and other intangibles   |           |             | 9,812      |
| Cash paid  |           |             | (7,059)    |
| Preferred stock issued   |           |             | (7,056)    |
| Issuance of common stock options   |           |             | (301)      |
| Fair value of liabilities assumed  |           |             | \$ 57,558  |

See accompanying notes to consolidated financial statements.



## Notes to Consolidated Financial Statements

### (1) Organization

Cardinal Financial Corporation (the "Company") was incorporated November 24, 1997 under the laws of the Commonwealth of Virginia as a holding company whose activities consist of investment in its wholly-owned subsidiaries. In addition to Cardinal Bank, N.A., which began operations in 1998, the Company opened the following three subsidiaries in 1999, Cardinal Wealth Services, Inc. an investment subsidiary (as of February 1, 1999), Cardinal Bank – Manassas/Prince William, N.A. (as of July 26, 1999), and Cardinal Bank – Dulles, N.A. (as of August 2, 1999). On September 1, 2000, the Company completed its acquisition of Heritage Bancorp, Inc. and its banking subsidiary, The Heritage Bank, headquartered in McLean, Virginia. The Heritage Bank was renamed and became the Company's fourth banking subsidiary, Cardinal Bank – Potomac. On November 1, 2001, the Company consolidated two of its banking subsidiaries, Cardinal Bank – Dulles, N.A. and Cardinal Bank – Potomac into Cardinal Bank, N.A. On March 1, 2002, the Company consolidated Cardinal Bank – Manassas/ Prince William, N.A. into Cardinal Bank, N.A., the Company's only remaining banking subsidiary.

### (2) Summary of Significant Accounting Policies

#### (a) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and contingent liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to changes in the near term are the allowance for loan losses, the valuation of deferred tax assets, and the determination of impairment on investment securities.

#### (b) Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

#### (c) Cash and Cash Equivalents

For the purpose of presentation in the consolidated statements of cash flows, the Company has defined cash and cash equivalents as those amounts included in cash, due from banks, and federal funds sold.

#### (d) Investment Securities

The Company classifies its debt and marketable equity securities in one of two categories: available-for-sale or held-to-maturity. Held-to-maturity securities are those securities for which the Company has the ability and intent to hold until maturity. All other securities are classified as available-for-sale.

Held to maturity securities are held at cost. Available-for-sale securities are recorded at fair value. Unrealized gains and losses, net of tax if applicable, on available-for-sale securities are reported in other comprehensive income (loss).

Gains and losses on the sale of securities are determined using the specific identification method. Declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost that are deemed other than temporary are charged to earnings as realized losses, resulting in the establishment of a new cost basis for the security.

Premiums and discounts are recognized in interest income using the effective interest method over the period to maturity. Prepayment of the mortgages securing the mortgage-backed securities may affect the maturity date and yield to maturity. The Company uses actual principal prepayment experience and estimates of future principal prepayments in calculating the yield necessary to apply the effective interest method.

#### (e) Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value on an individual loan basis as determined by outstanding commitments from investors. Net unrealized losses, if any, are recognized through a valuation allowance by charges to operations. Cost basis includes unpaid principal balances, origination premiums or discounts, and deferred net fees or costs.

#### (f) Loans Receivable and Allowance for Loan Losses

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal balance adjusted for any charge-offs, and net of the allowance for loan losses and any deferred fees or costs. Loan origination fees and certain direct origination costs are capitalized and amortized as an adjustment of the yield of the related loan.

Loans are placed in nonaccrual status when they are past-due 90 days as to either principal or interest or when, in the opinion of management, the collection of principal and interest is in doubt. A loan remains in nonaccrual status until the loan is current as to payment of both principal and interest or past-due less than 90 days, and the borrower demonstrates the ability to pay and remain current. Loans are charged-off when a loan or a portion thereof is considered uncollectible. When cash payments are received, they are applied to principal first, then accrued interest. It is the Company's policy not to record interest income on nonaccrual loans until principal has become current.

The Company determines and recognizes impairment of certain loans when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. A loan is not considered impaired during a period of delay in payment if the Company expects to collect all amounts due, including past-due interest. An impaired loan is measured at the present value of its expected future cash flows discounted at the loan's effective interest rate, or at the loan's observable market price or fair value of the collateral if the loan is collateral dependent.

The allowance for loan losses is increased by provisions for loan losses and decreased by charge-offs (net of recoveries). Management's periodic determination of the allowance is based on the Company's past loan loss experience, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, and current economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination. Management believes that the current allowance for loan losses is a reasonable estimate of known and inherent losses in the current loan portfolio.

#### (g) Premises and Equipment

Land is carried at cost. Premises, furniture, equipment, and leasehold improvements are carried at cost, less accumulated depreciation and amortization. Depreciation of premises, furniture and equipment is computed using the straight-line method over their estimated useful lives from 3 to 10 years. Amortization of leasehold improvements is computed using the straight-line method over the useful lives of the improvements or the lease term, whichever is shorter.

#### (h) Goodwill and Other Intangibles

Goodwill, which represents the excess of purchase price over fair value of net assets acquired, is evaluated at least annually for impairment by comparing its fair value with its recorded amount and is written-down when appropriate. Projected undiscounted net operating cash flows are compared to the carrying amount of the goodwill recorded and if the estimated

## Notes to Consolidated Financial Statements

undiscounted net operating cash flows are less than the carrying amount, a loss is recognized to reduce the carrying amount to fair value. In 2002, the Company evaluated impairment of goodwill under SFAS No. 142. The evaluation of goodwill under this statement did not result in impairment of the goodwill for the year ended December 31, 2002.

### (i) Investment Fee Income

Investment fee income represents commissions paid by customers of Cardinal Wealth Services, Inc. for investment transactions. Fees are recognized in income as they are earned.

### (j) Income Taxes

Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

### (k) Loss Per Common Share

Basic and diluted loss per common share is computed by dividing net loss by the weighted average number of shares of common stock outstanding during the periods. Common stock equivalents outstanding at December 31, 2002, 2001 and 2000 were antidilutive and consequently not included in the loss per common share calculation.

### (l) Stock Option Plan

The Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations, in accounting for its fixed plan stock options. As such, compensation expense is recorded only if the current market price of the underlying stock exceeded the exercise price on the date of grant.

### (m) Stock Based Compensation

At December 31, 2002, the Company had two stock-based employee compensation plans, which are described more fully in Footnote 14. As permitted under SFAS No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure*, which amended SFAS No. 123, *Accounting for Stock-Based Compensation*, the Company has elected to continue to follow the intrinsic value method in accounting for its stock-based employee compensation arrangement as defined by Accounting Principles Board Opinion ("APB") No. 25, *Accounting for Stock Issued to Employees*, and related interpretations including *Financial Accounting Standards Board Interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation*, an interpretation of APB No. 25. The following table illustrates the effect on net loss and loss per common share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation.

(Dollars in thousands, except per share data)

| Year ended December 31,   | 2002       | 2001        | 2000       |
|---|------------|-------------|------------|
| Net loss to common shareholders as reported   | \$ (1,024) | \$ (13,227) | \$ (4,142) |
| Deduct: Total stock based employee compensation expense determined under fair value-based method for all awards | (265)      | (138)       | (120)      |
| Pro forma net loss  | \$ (1,289) | \$ (13,365) | \$ (4,262) |
| Loss per common share:  |            |             |            |
| Basic - as reported   | \$ (0.13)  | \$ (3.11)   | \$ (0.98)  |
| Basic - pro forma   | (0.16)     | (3.14)      | (1.00)     |
| Diluted - as reported   | (0.13)     | (3.11)      | (0.98)     |
| Diluted - pro forma   | (0.16)     | (3.14)      | (1.00)     |

The weighted average per share fair values of grants made in 2002, 2001 and 2000 were \$2.12, \$2.04 and \$2.23, respectively. The fair values of the options granted were estimated on the grant date using the Black-Scholes option-pricing model based on the following weighted average assumptions:

|                         | 2002     | 2001     | 2000     |
|-------------------------|----------|----------|----------|
| Estimated option life   | 10 years | 10 years | 10 years |
| Risk free interest rate | 4.25%    | 4.90%    | 6.54%    |
| Expected volatility     | 20.4%    | 36.3%    | 33.5%    |
| Expected dividend yield | 0.00%    | 0.00%    | 0.00%    |

### (n) Reclassifications

Certain amounts for 2001 and 2000 have been reclassified to conform to the presentation for 2002.

### (3) Investment Securities and Other Investments

The fair value and amortized cost of available-for-sale securities as of December 31, 2002 and 2001 are shown below.

|   | 2002       |                |
|---|------------|----------------|
| (Dollars in thousands)  | Fair value | Amortized cost |
| Obligations of U.S. government-sponsored agencies and enterprises | \$ 39,036  | \$ 38,787      |
| Mortgage-backed securities  | 117,079    | 115,026        |
| Other bonds   | 5,000      | 5,000          |
| Treasury bonds  | 2,550      | 2,507          |
| Total   | \$ 163,665 | \$ 161,320     |

|   | 2001       |                |
|---|------------|----------------|
| (Dollars in thousands)  | Fair value | Amortized cost |
| Obligations of U.S. government-sponsored agencies and enterprises | \$ 4,458   | \$ 4,501       |
| Mortgage-backed securities  | 22,357     | 22,530         |
| Corporate bonds   | 7,083      | 7,140          |
| Treasury bonds  | 249        | 250            |
| Total   | \$ 34,147  | \$ 34,421      |

The fair value and amortized cost of available-for-sale securities by contractual maturity at December 31, 2002 is shown below. Expected maturities may differ from contractual maturities because many issuers have the right to call or prepay obligations with or without call or prepayment penalties.

|                                   | 2002       |                |
|-----------------------------------|------------|----------------|
| (Dollars in thousands)            | Fair value | Amortized cost |
| After 1 year but within 5 years   | 29,538     | 29,246         |
| After 5 years but within 10 years | 12,048     | 12,048         |
| After 10 years                    | 5,000      | 5,000          |
| Mortgage-backed securities        | 117,079    | 115,026        |
| Total                             | \$ 163,665 | \$ 161,320     |

For the years ended December 31, 2002, 2001, and 2000, proceeds from sales of investment securities available-for-sale amounted to \$31.3 million, \$0, and \$2.5 million, respectively. Gross realized gains in 2002 amounted to \$544,000. There were no realized gains during 2001 and 2000. Gross realized losses during 2002, 2001 and 2000 amounted to \$20,000, \$0 and \$32,000, respectively. The following table presents gross unrealized gains and losses in the investment securities available-for-sale portfolio as of December 31, 2002 and 2001.

## Notes to Consolidated Financial Statements

| 2002                              |                   |                           |         |               |
|-----------------------------------|-------------------|---------------------------|---------|---------------|
| <i>(Dollars in Thousands)</i>     | Amortized<br>Cost | Gross Unrealized<br>Gains | Losses  | Fair<br>Value |
| Maturing within 1 year            | \$ 15,478         | \$ 272                    | \$ —    | \$ 15,750     |
| After 1 year but within 5 years   | 99,798            | 2,093                     | (11)    | 101,880       |
| After 5 years but within 10 years | 25,743            | 7                         | (16)    | 25,734        |
| After 10 years                    | 20,301            | —                         | —       | 20,301        |
| Total                             | \$ 161,320        | \$ 2,372                  | \$ (27) | \$ 163,665    |

| 2001                              |                   |                           |          |               |
|-----------------------------------|-------------------|---------------------------|----------|---------------|
| <i>(Dollars in Thousands)</i>     | Amortized<br>Cost | Gross Unrealized<br>Gains | Losses   | Fair<br>Value |
| Maturing within 1 year            | \$ 432            | \$ 1                      | \$ (1)   | \$ 432        |
| After 1 year but within 5 years   | 20,595            | —                         | (148)    | 20,447        |
| After 5 years but within 10 years | 8,429             | 7                         | (94)     | 8,342         |
| After 10 years                    | 4,965             | 9                         | (48)     | 4,926         |
| Total                             | \$ 34,421         | \$ 17                     | \$ (291) | \$ 34,147     |

Investment securities available-for-sale that were pledged to secure short-term borrowings at December 31, 2002 and 2001 had fair values of \$20.0 million and \$1.3 million, respectively. At December 31, 2002 and 2001, investment securities available-for-sale that were pledged to secure repurchase agreements were \$0 and \$507,000, respectively. Investment securities available-for-sale that were pledged to secure debtor in possession deposit accounts and treasury, tax and loan payments at December 31, 2002 and 2001 were \$2.5 million and \$249,000, respectively.

Other investments at December 31, 2002 include \$933,000 of Federal Reserve Bank stock, \$619,000 of Federal Home Loan Bank stock, and \$63,000 of Community Bankers' Bank stock. As members of the Federal Reserve Bank of Richmond and Federal Home Loan Bank of Atlanta, the Company's banking subsidiaries are required to hold stock in these entities. Stock membership in Community Bankers' Bank allows the Company to participate in loan purchases or sales including participations. These investments are carried at cost since no active trading markets exist.

#### (4) Loans Receivable

The loan portfolio at December 31, 2002 and 2001 consists of the following:

| <i>(Dollars in thousands)</i> | 2002       | 2001       |
|-------------------------------|------------|------------|
| Commercial                    | \$ 58,292  | \$ 57,665  |
| Real estate – commercial      | 116,135    | 87,116     |
| Real estate – construction    | 5,781      | 6,397      |
| Real estate – residential     | 31,808     | 14,469     |
| Home equity lines             | 26,831     | 21,299     |
| Consumer                      | 10,235     | 13,941     |
|                               | 249,082    | 200,887    |
| Net deferred fees             | 24         | 24         |
| Loans receivable, net of fees | 249,106    | 200,911    |
| Allowance for loan losses     | (3,372)    | (3,104)    |
| Loans receivable, net         | \$ 245,734 | \$ 197,807 |

Most of the Company's loans, commitments and standby letters of credit have been granted to customers located in the Washington, D.C. metropolitan area. The concentrations of credit by type of loan are set forth in the previous table. As a matter of regulatory restriction, the Company's banking subsidiaries limit the amount of credit extended to any single borrower or group of related borrowers.

An analysis of the change in the allowance for loan losses follows:

| <i>(Dollars in thousands)</i>  | 2002     | 2001     | 2000     |
|--|----------|----------|----------|
| Balance, beginning of year   | \$ 3,104 | \$ 1,900 | \$ 726   |
| Provision for loan losses  | 444      | 1,202    | 753      |
| Transfer to bank's liability on unfunded commitments                         | (74)     | —        | —        |
| Assumed allowance for loan losses from acquisition of Heritage Bancorp, Inc. | —        | —        | 421      |
| Loans charged off  | (117)    | —        | —        |
| Recoveries   | 15       | 2        | —        |
| Balance, end of year   | \$ 3,372 | \$ 3,104 | \$ 1,900 |

As of December 31, 2002 and 2001, the Company had impaired loans of \$917,000 and \$361,000, respectively, which were on nonaccrual status. These impairments had valuation allowances of \$480,000 and \$193,000 as of December 31, 2002 and 2001, respectively. The average balance of impaired loans was \$568,000 and \$207,000 for 2002 and 2001, respectively. The Company recorded no interest income on impaired loans. Interest income that would have been recorded had these loans been performing would have been \$37,000 for 2002, \$17,000 for 2001 and \$34,000 for 2000.

## Notes to Consolidated Financial Statements

### (5) Premises and Equipment

Components of premises and equipment at December 31, 2002 and 2001 were as follows:

| <i>(Dollars in thousands)</i>                  | 2002     | 2001     |
|--|----------|----------|
| Land   | \$ 197   | \$ 197   |
| Building                                       | 789      | 789      |
| Furniture and equipment                        | 4,304    | 3,834    |
| Leasehold improvements                         | 2,351    | 2,161    |
| Total cost                                     | 7,641    | 6,981    |
| Less accumulated depreciation and amortization | 2,699    | 1,904    |
| Premises and equipment, net                    | \$ 4,942 | \$ 5,077 |

Depreciation expense for the years ended December 31, 2002, 2001 and 2000 was \$736,000, \$804,000 and \$601,000, respectively.

The Company has entered into leases for office space over various terms. The leases are subject to annual increases as well as allocations of real estate taxes and certain operating expenses.

Minimum future rental payments under the noncancelable operating leases, as of December 31, 2002 for each of the next five years and in the aggregate, are as follows:

| <i>(Dollars in thousands)</i> | Amount   |
|-------------------------------|----------|
| Year ending December 31,      |          |
| 2003                          | \$ 1,273 |
| 2004                          | 997      |
| 2005                          | 1,027    |
| 2006                          | 958      |
| 2007                          | 942      |
| Thereafter                    | 1,556    |
|                               | \$ 6,753 |

The total rent expense was \$1.3 million, \$1.3 million and \$965,000 in 2002, 2001 and 2000, respectively.

In 2002 and 2001, the Company entered into contracts as sublessor for excess office space. Future minimum lease payment receivables under noncancelable leasing arrangements as of December 31, 2002 for each of the next five years and in the aggregate are as follows:

| <i>(Dollars in thousands)</i> | Amount   |
|-------------------------------|----------|
| Year ending December 31,      |          |
| 2003                          | \$ 355   |
| 2004                          | 277      |
| 2005                          | 241      |
| 2006                          | 245      |
| 2007                          | 181      |
| Thereafter                    | 713      |
|                               | \$ 2,012 |

The total rent income was \$409,000, \$110,000 and \$0 in 2002, 2001 and 2000, respectively.

### (6) Deposits

Deposits consist of the following at December 31, 2002 and 2001:

| <i>(Dollars in thousands)</i>      | 2002       | 2001       |
|------------------------------------|------------|------------|
| Demand deposits                    | \$ 72,962  | \$ 61,739  |
| Interest checking                  | 146,041    | 45,313     |
| Money market and statement savings | 31,078     | 28,676     |
| Certificates of deposit            | 173,398    | 110,296    |
|                                    | \$ 423,479 | \$ 246,024 |

Interest expense by deposit categories is as follows:

| <i>(Dollars in thousands)</i>      | 2002     | 2001     | 2000     |
|------------------------------------|----------|----------|----------|
| Interest checking                  | \$ 3,073 | \$ 370   | \$ 130   |
| Money market and statement savings | 577      | 869      | 685      |
| Certificates of deposit            | 5,714    | 5,788    | 3,478    |
|                                    | \$ 9,364 | \$ 7,027 | \$ 4,293 |

The aggregate amount of time deposits, each with a minimum denomination of \$100,000 was \$80.0 million and \$59.8 million at December 31, 2002 and 2001, respectively.

At December 31, 2002, the scheduled maturities of certificates of deposit are as follows:

| <i>(Dollars in thousands)</i> | Amount     |
|-------------------------------|------------|
| 2003                          | \$ 68,398  |
| 2004                          | 60,405     |
| 2005                          | 14,961     |
| 2006                          | 11,893     |
| 2007 and thereafter           | 17,741     |
|                               | \$ 173,398 |

## Notes to Consolidated Financial Statements

### (7) Other Borrowed Funds

The Company has advances from the Federal Home Loan Bank of Atlanta of \$2.0 million and \$9.8 million at December 31, 2002 and 2001, respectively. As of December 31, 2002, 2001 and 2000, the Company had the following advances outstanding:

(Dollars in thousands)

As of December 31, 2002

| Advance Date | Interest Rate | Term of Advance | Amount<br>Date Due | Outstanding |
|--------------|---------------|-----------------|--------------------|-------------|
| 09/19/2001   | 3.70%         | 24 months       | 09/19/2003         | \$ 1,000    |
| 10/11/2002   | 1.96%         | 6 months        | 04/11/2003         | 1,000       |
|              | 2.83%         |                 |                    | \$ 2,000    |

As of December 31, 2001

| Advance Date | Interest Rate | Term of Advance | Amount<br>Date Due | Outstanding |
|--------------|---------------|-----------------|--------------------|-------------|
| 03/19/2001   | 4.68%         | 12 months       | 03/19/2002         | \$ 1,800    |
| 03/19/2001   | 4.68%         | 12 months       | 03/19/2002         | 1,000       |
| 08/06/2001   | 4.05%         | 12 months       | 08/06/2002         | 3,000       |
| 08/28/2001   | 3.89%         | 12 months       | 08/28/2002         | 3,000       |
| 09/19/2001   | 3.70%         | 24 months       | 09/19/2003         | 1,000       |
|              | 4.15%         |                 |                    | \$ 9,800    |

As of December 31, 2000

| Advance Date | Interest Rate | Term of Advance | Amount<br>Date Due | Outstanding |
|--------------|---------------|-----------------|--------------------|-------------|
| 12/12/2000   | 6.70%         | 3 months        | 03/12/2001         | \$ 3,000    |
| 12/26/2000   | 6.42%         | 4 months        | 04/26/2001         | 3,000       |
|              | 6.56%         |                 |                    | \$ 6,000    |

The average balances of short-term borrowings for the years ended December 31, 2002, 2001 and 2000 were \$5.6 million, \$9.0 million, and \$6.0 million, respectively. The maximum amount outstanding at any month-end during the years ended December 31, 2002, 2001 and 2000 was \$9.8 million, \$9.8 million, and \$6.0 million, respectively. Total interest expense on short-term borrowings for the years ended December 31, 2002, 2001 and 2000 was \$222,000, \$448,000 and \$398,000, respectively.

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The Company is required to provide additional collateral based on the fair value of the underlying securities.

As of December 31, 2002 the Company had no repurchase agreements. As of December 31, 2001, and 2000, the Company had repurchase agreements of \$24,000 and \$1.3 million at a rate of 0.50% and 5.00%, respectively. The average balances of the repurchase agreements for 2002, 2001 and 2000 were \$0, \$1.0 million and \$929,000, respectively, and the maximum amount outstanding at any month-end during 2001 and 2000 were \$1.6 million and \$3.7 million, respectively. Interest expense on repurchase agreements for 2002, 2001 and 2000 was \$0, \$25,000 and \$49,000, respectively.

### (8) Preferred Stock

In connection with the acquisition of Heritage Bancorp, Inc. on September 1, 2000, the Company issued 1,411,268 shares of Series A Preferred Stock, cumulative convertible. Shares of the Preferred Stock outstanding at December 31, 2002 and 2001 were 1,364,684 and 1,364,714, respectively. The

Series A Preferred Stock has a par value of \$1.00 per share and a liquidation preference of \$5.00 per share. It is redeemable by the Company at any time on or after March 31, 2004 if the Company's common stock trades at a price above \$8.65 for 20 consecutive days at a redemption price of \$5.00 per share. Dividends on the Series A Preferred Stock are payable quarterly for a cumulative annual dividend of \$0.3625 or 7.25% of the \$5.00 liquidation amount, before any dividend is paid on any Cardinal common stock. Holders of Series A Preferred Stock have the right to convert 1 share of Series A Preferred Stock for 0.75 shares of Cardinal common stock at any time. Holders of Series A Preferred Stock are not entitled to receive notice of, or to participate in, or to vote on any matter at any meeting of the shareholders, except to the extent that they are afforded a vote by the laws of the Commonwealth of Virginia in existence at the time any matter requiring such a vote shall arise. Notwithstanding the lack of voting rights, under Sections 13.1-707 and 708 of the Virginia Stock Corporation Act the holders of the Series A Preferred Stock are entitled to notice of any meeting of the shareholders considering an amendment to our Articles of Incorporation relating to any of the matters described in Section 13.1-708 of the Virginia Stock Corporation Act and to vote as a class.

### (9) Income Taxes

The Company and its subsidiaries file consolidated tax returns on a calendar-year basis. The Company had no provision for current and deferred income taxes for the years ended December 31, 2002, 2001 and 2000, respectively.

## Notes to Consolidated Financial Statements

The provision for income taxes is reconciled to the amount computed by applying the federal corporate tax rate to income before taxes and is as follows:

| (Dollars in thousands)                         | 2002     | 2001       | 2000       |
|--|----------|------------|------------|
| Income tax (benefit) at federal corporate rate | \$ (180) | \$ (4,326) | \$ (1,350) |
| Nondeductible expenses                         | 7        | 2,998      | 90         |
| Change in valuation allowance                  | 173      | 1,328      | 1,260      |
|  | \$ —     | \$ —       | \$ —       |

The tax benefits of temporary differences between the financial reporting basis and income tax basis of assets and liabilities relate to the following:

| (Dollars in thousands)                                      | 2002     | 2001    |
|---|----------|---------|
| Deferred tax assets:  |          |         |
| Bad debts   | \$ 1,047 | \$ 910  |
| Organization and other costs                                | 19       | 46      |
| Net operating loss carryforwards                            | 4,401    | 4,482   |
| Unrealized (gains) losses on investments available-for-sale | (797)    | 95      |
| Other   | 157      | 154     |
| Total gross deferred assets                                 | 4,827    | 5,687   |
| Less valuation allowance                                    | (4,553)  | (5,365) |
| Net deferred tax assets                                     | 274      | 322     |
| Deferred tax liabilities:                                   |          |         |
| Prepaid expenses  | (19)     | (31)    |
| Depreciation  | (134)    | (154)   |
| Loan origination costs                                      | (121)    | (135)   |
| Other   | —        | (2)     |
| Total gross deferred tax liabilities                        | (274)    | (322)   |
| Net deferred tax asset                                      | \$ —     | \$ —    |

Deferred income taxes reflect temporary differences in the recognition of revenue and expenses for tax reporting and financial statement purposes, principally because certain items, such as depreciation and amortization, are recognized in different periods for financial reporting and tax return purposes. A valuation allowance in the amount of \$4.5 million at December 31, 2002 and \$5.4 million at December 31, 2001 has been established for deferred tax assets, as realization is dependent upon generating future taxable income.

### Risk Based Capital Information

| As of December 31, 2002                | Actual    |        | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|--|-----------|--------|-------------------------------|-------|--|--------|
|  | Amount    | Ratio  | Amount                        | Ratio | Amount   | Ratio  |
| (Dollars in thousands)                 |           |        |                               |       |  |        |
| Total capital to risk weighted assets  | \$ 41,093 | 13.35% | \$ 24,625 ≥                   | 8.00% | \$ 30,781 ≥  | 10.00% |
| Tier I capital to risk weighted assets | 37,721    | 12.25% | 12,313 ≥                      | 4.00% | 18,469 ≥   | 6.00%  |
| Tier I capital to average assets       | 37,721    | 8.97%  | 18,330 ≥                      | 4.00% | 15,391 ≥   | 5.00%  |

| As of December 31, 2001                | Actual    |        | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|--|-----------|--------|-------------------------------|-------|--|--------|
|  | Amount    | Ratio  | Amount                        | Ratio | Amount   | Ratio  |
| (Dollars in thousands)                 |           |        |                               |       |  |        |
| Total capital to risk weighted assets  | \$ 23,333 | 10.42% | \$ 17,909 ≥                   | 8.00% | \$ 22,387 ≥  | 10.00% |
| Tier I capital to risk weighted assets | 20,230    | 9.04%  | 8,955 ≥                       | 4.00% | 13,432 ≥   | 6.00%  |
| Tier I capital to average assets       | 20,230    | 8.57%  | 10,891 ≥                      | 4.00% | 13,614 ≥   | 5.00%  |

The Company has net operating loss carryforwards of approximately \$12.9 million at December 31, 2002, which are available to offset future taxable income. \$1.9 million of the net operating loss carryforwards is subject to annual limitation on utilization. The Company's net operating loss carryforwards expire as follows: \$1.5 million in 2018, \$3.6 million in 2019, \$5.1 million in 2020, and \$2.7 in 2021.

### (10) Regulatory Matters

The Company's banking subsidiary, Cardinal Bank, N.A. (the "Bank"), as a national bank, is subject to the dividend restrictions established by the Comptroller of the Currency. Under such restrictions, the Bank may not, without the prior approval of the Comptroller of the Currency, declare dividends in excess of the sum of the current year's earnings (as defined) plus the retained earnings (as defined) from the prior two years. At December 31, 2002, there were no earnings against which dividends could be paid.

The Bank is required to maintain a minimum average reserve balance with the Federal Reserve Bank. The average amount of the required reserve was \$10.2 million for 2002. As members of the Federal Reserve Bank system, the Bank is required to subscribe to shares of \$100 par value Federal Reserve Bank stock equal to 6 percent of the Bank's capital and surplus. The Bank is required to pay for one-half of the subscription. The remaining amount is subject to call when deemed necessary by the Board of Governors of the Federal Reserve.

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") requires the regulators to stratify institutions into five quality tiers based upon their relative capital strengths and to increase progressively the degree of regulation over the weaker institutions, limits the pass through deposit insurance treatment of certain types of accounts, adopts a "truth in savings" program, calls for the adoption of risk-based premiums on deposit insurance and requires the Bank to observe insider credit underwriting products no less strict than those applied to comparable noninsider transactions.

At December 31, 2002 and 2001, the Company and the Bank met all regulatory capital requirements. The key measures of capital are: (1) total capital (Tier I capital plus the allowance for loan losses up to certain limitations) as a percent of total risk-weighted assets, (2) Tier I capital (as defined) as a percent of total risk-weighted assets (as defined), and (3) Tier I capital (as defined) as a percent of total assets (as defined).

## Notes to Consolidated Financial Statements

### (11) Related-Party Transactions

Officers, directors, employees and their related business interests are loan customers in the ordinary course of business. In management's opinion, these loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans with other persons and do not involve more than normal risk of collectibility or present other unfavorable features.

Analysis of activity for loans to related parties is as follows:

| (Dollars in thousands)      | 2002     |
|-----------------------------|----------|
| Balance, beginning of year  | \$ 2,727 |
| New loans                   | 2,177    |
| Loans paid off or paid down | (152)    |
| Balance, end of year        | \$ 4,752 |

### (12) Loss Per Common Share

The following is the calculation of basic and diluted loss per common share. Because the Company has net losses, all stock options issued have an anti-dilutive effect and, therefore, have been excluded from the loss per common share calculation.

| (Dollars and shares in thousands)             | 2002       | 2001        | 2000       |
|---|------------|-------------|------------|
| Net loss                                      | \$ (529)   | \$ (12,724) | \$ (3,971) |
| Dividends to preferred shareholders           | 495        | 503         | 171        |
| Net loss to common shareholders               | \$ (1,024) | \$ (13,227) | \$ (4,142) |
| Weighted average shares for basic and diluted | 7,949      | 4,258       | 4,246      |
| Basic loss per common share                   | \$ (0.13)  | \$ (3.11)   | \$ (0.98)  |
| Diluted loss per common share                 | \$ (0.13)  | \$ (3.11)   | \$ (0.98)  |

### (13) Employee Benefit Plan

The Company established a 401(k) plan in January 1998 for all eligible employees. The Company began to match a portion of employee contributions beginning January 1, 1999. The Company's match for December 31, 2002, 2001 and 2000 was \$102,000, \$118,000 and \$109,000, respectively.

### (14) Director and Employee Stock Compensation Plans

In 1998, the Company adopted a stock option plan (the "Plan") pursuant to which the Company may grant stock options to employees and members of the Company's and its' subsidiaries' Boards of Directors. The Company has granted options to purchase up to 625,000 shares of common stock as of December 31, 2002.

In 1999, the Company granted stock awards to an employee. These awards became fully vested in 2001. For the years ended December 31, 2002, 2001 and 2000, the Company recognized \$0, \$6,000 and \$12,000, respectively, in compensation expense related to the stock awards.

Stock options are granted with an exercise price equal to the stock's fair market value at the date of grant. Director stock options have 10-year terms and vest and become fully exercisable immediately. Certain employee stock options have 10-year terms and vest and become fully exercisable after 3 years. Other employee stock options have 10-year terms and vest and become fully exercisable in 20% increments beginning after their first year of vesting.

Stock option activity during the years indicated is as follows:

|                              | Number of Shares | Weighted Average Exercise Price |
|------------------------------|------------------|---------------------------------|
| Balance at December 31, 2000 | 325,212          | \$ 5.74                         |
| Granted                      | 130,740          | 4.07                            |
| Exercised                    | (2,809)          | 3.75                            |
| Forfeited                    | (85,115)         | 5.77                            |
| Expired                      | —                | —                               |
| Balance at December 31, 2001 | 368,028          | \$ 5.23                         |
| Granted                      | 265,530          | 3.27                            |
| Exercised                    | —                | —                               |
| Forfeited                    | (90,665)         | 5.48                            |
| Expired                      | —                | —                               |
| Balance at December 31, 2002 | 542,893          | \$ 4.22                         |

At December 31, 2002, the range of exercise prices and weighted-average remaining contractual life of outstanding options were \$2.41 - \$10.00 and 8.0 years, respectively. At December 31, 2001, the range of exercise prices and weighted-average remaining contractual life of outstanding options were \$2.41 - \$10.00 and 7.7 years, respectively. As of December 31, 2002 and 2001, the outstanding options exercisable were 279,634 and 171,793, respectively. The weighted average exercise price for the outstanding options exercisable as of December 31, 2002 and 2001 are \$4.71 and \$4.48, respectively.

Information pertaining to options outstanding at December 31, 2002 is as follows:

| Range of Exercise Prices | Options Outstanding |                            |                                 | Options Exercisable |                                 |
|--------------------------|---------------------|----------------------------|---------------------------------|---------------------|---------------------------------|
|                          | Number Outstanding  | Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable  | Weighted Average Exercise Price |
| \$2.41 - \$3.56          | 333,365             | 8.4 years                  | \$ 3.27                         | 143,585             | \$ 3.29                         |
| \$3.95 - \$5.50          | 103,690             | 7.9 years                  | 4.68                            | 30,211              | 4.22                            |
| \$6.38 - \$7.00          | 105,088             | 6.4 years                  | 6.77                            | 105,088             | 6.77                            |
| \$10.00 - \$10.00        | 750                 | 5.9 years                  | 10.00                           | 750                 | 10.00                           |
| Outstanding at year end  | 542,893             | 8.0 years                  | \$ 4.22                         | 279,634             | \$ 4.71                         |

## Notes to Consolidated Financial Statements

At December 31, 2002 and 2001, additional shares available for grant under the Plan were 72,039 and 246,904, respectively. The per share weighted-average fair value of stock options granted during 2002 and 2001 was \$2.12 and \$2.04, respectively, on the date of grant using the Black Scholes option-pricing model (using an expected volatility over the expected life of the options of 20.4 percent and 36.3 percent, respectively). As of December 31, 2002 the weighted-average assumptions were as follows: expected dividend yield 0.00 percent, risk-free interest rate of 4.25 percent, and an expected life of 10 years. As of December 31, 2001, the weighted-average assumptions were as follows: expected dividend yield 0.00 percent, risk-free interest rate of 4.90 percent, and an expected life of 10 years.

The Company applies APB Opinion No. 25 in accounting for its Plan and, accordingly, no compensation cost has been recognized for its stock options. Had the Company determined compensation cost based on the fair value at the grant date for its stock options under SFAS No. 123, the Company's net loss would have been increased to the pro forma amounts indicated below:

| (Dollars in thousands)           | 2002       | 2001        | 2000       |
|----------------------------------|------------|-------------|------------|
| Net loss to common shareholders: |            |             |            |
| As reported                      | \$ (1,024) | \$ (13,227) | \$ (4,142) |
| Pro forma                        | (1,289)    | (13,365)    | (4,262)    |
| Loss per common share:           |            |             |            |
| As reported                      | \$ (0.13)  | \$ (3.11)   | \$ (0.98)  |
| Pro forma                        | (0.16)     | (3.14)      | (1.00)     |

Information about reportable segments, and reconciliation of such information to the consolidated financial statements as of and for the years ended December 31, 2002, 2001 and 2000 follows:

(Dollars in thousands)

| December 31, 2002         |                       |                        |           |                             |              |
|---------------------------|-----------------------|------------------------|-----------|-----------------------------|--------------|
|                           | Commercial<br>Banking | Investment<br>Advisory | Other     | Intersegment<br>Elimination | Consolidated |
| Net interest income       | \$ 10,575             | \$ —                   | \$ 81     | \$ —                        | \$ 10,656    |
| Provision for loan losses | 444                   | —                      | —         | —                           | 444          |
| Non-interest income       | 2,122                 | 942                    | 209       | —                           | 3,273        |
| Non-interest expense      | 12,269                | 1,147                  | 598       | —                           | 14,014       |
| Net loss                  | \$ (16)               | \$ (205)               | \$ (308)  | \$ —                        | \$ (529)     |
| Total assets              | \$ 483,135            | \$ 274                 | \$ 41,159 | \$ (38,245)                 | \$ 486,323   |

| December 31, 2001         |                       |                        |            |                             |              |
|---------------------------|-----------------------|------------------------|------------|-----------------------------|--------------|
|                           | Commercial<br>Banking | Investment<br>Advisory | Other      | Intersegment<br>Elimination | Consolidated |
| Net interest income       | \$ 9,051              | \$ —                   | \$ 26      | \$ —                        | \$ 9,077     |
| Provision for loan losses | 1,202                 | —                      | —          | —                           | 1,202        |
| Non-interest income       | 1,210                 | 1,947                  | 116        | —                           | 3,267        |
| Non-interest expense      | 19,220                | 2,034                  | 2,612      | —                           | 23,866       |
| Net loss                  | \$ (10,161)           | \$ (87)                | \$ (2,470) | \$ —                        | \$ (12,724)  |
| Total assets              | \$ 277,930            | \$ 420                 | \$ 23,228  | \$ (21,994)                 | \$ 279,584   |

During 2002, the shareholders approved the Company's 2002 Equity Compensation Plan. The Equity Plan authorizes the granting of options, which may either be Incentive Stock Options, Non-Qualified Stock Options, stock appreciation rights, restricted stock awards, phantom stock awards and performance share awards to directors, eligible officers and key employees of the Company. The Equity Plan authorizes the issuance of options and other equity instruments equivalent to 700,000 shares, or 6.32% of the outstanding shares of common stock plus shares of common stock issuable upon conversion of the Company's outstanding Series A Preferred Stock. No shares were granted under the 2002 Equity Compensation Plan as of December 31, 2002.

### (15) Segment Reporting

The Company operates and reports in two business segments, commercial banking and investment advisory services. The commercial banking segment includes both commercial and consumer lending and provides customers such products as commercial loans, real estate loans, and other business financing and consumer loans. In addition, this segment also provides customers with several choices of deposit products including demand deposit accounts, savings accounts and certificates of deposit. The investment advisory services segment provides advisory services to businesses and individuals including financial planning and retirement/estate planning.



## Notes to Consolidated Financial Statements

December 31, 2000

|                           | Commercial<br>Banking | Investment<br>Advisory | Other      | Intersegment<br>Elimination | Consolidated |
|---------------------------|-----------------------|------------------------|------------|-----------------------------|--------------|
| Net interest income       | \$ 5,914              | \$ —                   | \$ 496     | \$ —                        | \$ 6,410     |
| Provision for loan losses | 753                   | —                      | —          | —                           | 753          |
| Non-interest income       | 574                   | 1,515                  | 13         | (4)                         | 2,098        |
| Non-interest expense      | 6,695                 | 1,990                  | 3,045      | (4)                         | 11,726       |
| Net loss                  | \$ (960)              | \$ (475)               | \$ (2,536) | \$ —                        | \$ (3,971)   |
| Total assets              | \$ 193,641            | \$ 176                 | \$ 35,014  | \$ (21,783)                 | \$ 207,048   |

The Company does not have operating segments other than those reported. Parent Company financial information is included in the Other category and represents the overhead function rather than an operating segment.

### (16) Financial Instruments with Off Balance Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit and financial guarantees. Commitments to extend credit are agreements to lend to a customer so long as there is no violation of any condition established in the contract. Commitments usually have fixed expiration dates up to one year or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of the contractual obligations by a customer to a third party. The majority of these guarantees extend until satisfactory completion of the customer's contractual obligations. All standby letters of credit outstanding at December 31, 2002 are collateralized.

Those instruments represent obligations of the Company to extend credit or guarantee borrowings; and therefore, are not recorded on the consolidated statements of financial condition. The rates and terms of these instruments are competitive with others in the market in which the Company operates. Almost all of these instruments as of December 31, 2002 have floating rates, thereby significantly mitigating the market risk.

Those instruments may involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated statements of financial condition. Credit risk is defined as the possibility of sustaining a loss because the other parties to a financial instrument fail to perform in accordance with the terms of the contract. The Company's maximum exposure to credit loss under standby letters of credit and commitments to extend credit is represented by the contractual amounts of those instruments.

(Dollars in thousands)

| Financial instruments whose contract amounts represent potential credit risk: | 2002      | 2001      |
|---|-----------|-----------|
| Commitments to extend credit  | \$ 66,767 | \$ 56,382 |
| Standby letters of credit   | 1,610     | 3,168     |

The Company had no recorded liability associated with standby letters of credit at December 31, 2002.

The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. The Company evaluates each customer's creditworthiness on a case-by-case basis and requires collateral to support financial instruments when deemed necessary. The amount of collateral obtained upon extension of credit is based on management's evaluation of the counterparty. Collateral held varies but may include deposits held by the Company, marketable securities, accounts

receivable, inventory, property, plant and equipment, and income-producing commercial properties.

### (17) Disclosures of Fair Value of Financial Instruments

The assumptions used and the estimates disclosed represent management's best judgment of appropriate valuation methods. These estimates are based on pertinent information available to management at the valuation date. In certain cases, fair values are not subject to precise quantification or verification and may change as economic and market factors, and management's evaluation of those factors, change.

Although management uses its best judgment in estimating the fair value of these financial instruments, there are inherent limitations in any estimation technique. Therefore, these fair value estimates are not necessarily indicative of the amounts the Company would realize in a market transaction. Because of the wide range of valuation techniques and the numerous estimates which must be made, it may be difficult to make reasonable comparisons of the Company's fair value information to that of other financial institutions. It is important that the many uncertainties discussed above be considered when using the estimated fair value disclosures and that, because of these uncertainties, the aggregate fair value amount should in no way be construed as representative of the underlying value of the Company.

#### Fair Value of Financial Instruments

The following summarizes the significant methodologies and assumptions used in estimating the fair values presented in the accompanying table.

#### Cash and Cash Equivalents

The carrying amount of cash and cash equivalents is used as a reasonable estimate of fair value.

#### Investment Securities and Other Investments

Fair values for investment securities are based on quoted market prices or prices quoted for similar financial instruments. Fair value for other investments is estimated as their cost since no active trading markets exist.

#### Loans Held for Sale

Loans held for sale are valued based on quoted market prices from secondary market investors with commitments to purchase the loans.

#### Loans Receivable

In order to determine the fair market value for loans receivable, the loan portfolio was segmented based on loan type, credit quality and maturities. For certain variable rate loans with no significant credit concerns and frequent repricings, estimated fair values are based on current carrying amounts. The fair values of other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

## Notes to Consolidated Financial Statements

### Deposits

The fair values disclosed for demand deposits are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of variable rate, fixed-term money market accounts and certificates of deposit (CDs) approximate their fair value at the reporting date. Fair values for fixed-rate CDs are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

### Other Borrowed Funds

The fair value of borrowings is estimated using a discounted cash flow calculation that applies an interest rate currently available with similar terms.

### Commitments

The fair value of these financial instruments is based on the credit quality and relationship, fees, interest rates, probability of funding, compensating balance and other covenants or requirements. These commitments generally have fixed expiration dates expiring within one year. Many commitments are expected to, and typically do, expire without being drawn upon. The rates and terms of these instruments are competitive with others in the market in which the Company operates. The carrying amounts are reasonable estimates of the fair value of these financial instruments. The carrying amounts of these instruments are zero at December 31, 2002 and 2001.

### Accrued Interest

The carrying amounts of accrued interest approximate their fair values.

Fair value of financial instruments as of December 31, 2002 and 2001:

|   | December 31, 2002 |                      |
|---|-------------------|----------------------|
| (Dollars in thousands)                      | Carrying Amount   | Estimated Fair Value |
| Financial assets:                           |                   |                      |
| Cash and cash equivalents                   | \$ 63,371         | \$ 63,371            |
| Investment securities and other investments | 165,280           | 165,280              |
| Loans receivable                            | 249,106           | 257,480              |
| Accrued interest receivable                 | 1,523             | 1,523                |
| Financial liabilities:                      |                   |                      |
| Demand deposits                             | \$ 72,962         | \$ 72,962            |
| Interest checking                           | 146,041           | 146,041              |
| Money market and statement savings          | 31,078            | 31,078               |
| Certificates of deposit                     | 173,398           | 178,360              |
| Other borrowed funds                        | 2,000             | 2,000                |
| Accrued interest payable                    | 107               | 107                  |

|   | December 31, 2001 |                      |
|---|-------------------|----------------------|
| (Dollars in thousands)                      | Carrying Amount   | Estimated Fair Value |
| Financial assets:                           |                   |                      |
| Cash and cash equivalents                   | \$ 34,459         | \$ 34,459            |
| Investment securities and other investments | 35,415            | 35,415               |
| Loans held for sale                         | 4,732             | 4,760                |
| Loans receivable                            | 200,911           | 200,143              |
| Accrued interest receivable                 | 1,090             | 1,090                |
| Financial liabilities:                      |                   |                      |
| Demand deposits                             | \$ 61,739         | \$ 61,739            |
| Interest checking                           | 45,313            | 45,313               |
| Money market and statement savings          | 28,676            | 28,676               |
| Certificates of deposit                     | 110,296           | 114,629              |
| Other borrowed funds                        | 9,824             | 9,824                |
| Accrued interest payable                    | 12                | 12                   |

### (18) Parent Company Only Financial Statements

The Cardinal Financial Corporation (parent company only) condensed financial statements are as follows:

#### Parent Company Only Condensed Statements of Condition

December 31, 2002 and 2001

(Dollars in thousands)

| Assets                                     | 2002      | 2001      |
|--|-----------|-----------|
| Cash and cash equivalents                  | \$ 5,989  | \$ 2,584  |
| Other investments                          | 63        | 67        |
| Investment in subsidiaries                 | 32,472    | 17,799    |
| Premises and equipment, net                | 1,825     | 1,986     |
| Goodwill and other intangibles, net        | 646       | 668       |
| Other assets                               | 164       | 124       |
| Total assets                               | \$ 41,159 | \$ 23,228 |
| Liabilities and Shareholders' Equity       |           |           |
| Total liabilities                          | \$ 447    | \$ 2,604  |
| Total shareholders' equity                 | \$ 40,712 | \$ 20,624 |
| Total liabilities and shareholders' equity | \$ 41,159 | \$ 23,228 |

#### Parent Company Only Condensed Statements of Operations

Years Ended December 31, 2002, 2001 and 2000

(Dollars in thousands)

|   | 2002     | 2001        | 2000       |
|---|----------|-------------|------------|
| Income:   |          |             |            |
| Interest income   | \$ 81    | \$ 26       | \$ 496     |
| Other income  | 209      | 116         | 13         |
| Total income  | 290      | 142         | 509        |
| Expense - General and administrative  | 598      | 2,612       | 3,045      |
| Net loss before income taxes and equity in undistributed earnings of subsidiaries | (308)    | (2,470)     | (2,536)    |
| Provision for income taxes  | —        | —           | —          |
| Equity in undistributed earnings of subsidiaries                                  | (221)    | (10,254)    | (1,435)    |
| Net loss  | \$ (529) | \$ (12,724) | \$ (3,971) |

## Notes to Consolidated Financial Statements

### Parent Company Only Condensed Statements of Cash Flows

Years ended December 31, 2002, 2001 and 2000

(Dollars in thousands)

|   | 2002     | 2001        | 2000       |
|---|----------|-------------|------------|
| Cash flows from operating activities:   |          |             |            |
| Net loss  | \$ (529) | \$ (12,724) | \$ (3,971) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |          |             |            |
| Equity in undistributed earnings of subsidiaries  | 221      | 1,984       | 1,435      |
| Depreciation and amortization and write down of goodwill                                  | 238      | 9,129       | 465        |
| Increase in other assets and liabilities  | (2,413)  | 1,754       | 543        |
| Net cash provided by (used in) operating activities                                       | (2,483)  | 143         | (1,528)    |
| Cash flows from investing activities:   |          |             |            |
| Capital infusions in subsidiaries   | (12,275) | (720)       | (750)      |
| Dividends from subsidiary   | —        | —           | 3,000      |
| Net change in premises and equipment  | 161      | 158         | (62)       |
| Proceeds from sale and redemptions of securities  | —        | —           | 2,468      |
| Proceeds from sale of other investments   | 4        | 17          | —          |
| Cash paid in acquisition  | —        | —           | (7,726)    |
| Net cash used in investing activities   | (12,110) | (545)       | (3,070)    |
| Cash flows from financing activities:   |          |             |            |
| Proceeds from rights and secondary offerings  | 18,493   | —           | —          |
| Dividends declared on preferred stock   | (495)    | (503)       | (170)      |
| Stock options exercised   | —        | 11          | 22         |
| Net cash provided by (used in) financing activities                                       | 17,998   | (492)       | (148)      |
| Net increase (decrease) in cash and cash equivalents                                      | 3,405    | (894)       | (4,746)    |
| Cash and cash equivalents at beginning of year  | 2,584    | 3,478       | 8,224      |
| Cash and cash equivalents at end of year  | \$ 5,989 | \$ 2,584    | \$ 3,478   |

### (19) Goodwill and Other Intangible Assets

At December 31, 2002, goodwill of \$646,000 represents the remaining balance attributable to the purchase of Heritage Bancorp, Inc. In 2001, the Company substantially eliminated the goodwill attributable from this acquisition. The initial investment in Heritage, which was subsequently, renamed Cardinal Bank – Potomac, resulted in the Company recording \$9.7 million of goodwill at the time of the acquisition. In the fourth quarter of 2001, an evaluation of current year losses and expectations of additional future losses indicated a potential impairment in the Company's investment in Heritage. In compliance with SFAS No. 121, the Company wrote down goodwill by \$8.3 million based upon a valuation obtained from an independent third party consultant.

## Notes to Consolidated Financial Statements

The Company adopted SFAS No. 142 as of January 1, 2002, and, therefore, discontinued the amortization of goodwill on January 1, 2002, which had the effect of decreasing the Company's net loss by \$35,000. The Company has evaluated impairment of goodwill under SFAS No. 142. The evaluation of goodwill under this statement did not result in impairment of the Company's goodwill as of the annual evaluation date. Information on the Company's intangible assets is contained in the table below.

|                                       | December 31, 2002       |                          | December 31, 2001    |                          |
|---------------------------------------|-------------------------|--------------------------|----------------------|--------------------------|
| (Dollars in thousands)                | Gross Carrying Value    | Accumulated Amortization | Gross Carrying Value | Accumulated Amortization |
| Amortizable core deposit intangible   | \$ 102                  | \$ (102)                 | \$ 102               | \$ (80)                  |
| Unamortizable goodwill                | 646                     | —                        | 646                  | —                        |
|                                       | Core Deposit Intangible | Goodwill                 |                      |                          |
| Amortization expense:                 |                         |                          |                      |                          |
| Twelve months ended December 31, 2002 | \$ 22                   | \$ —                     |                      |                          |
| Twelve months ended December 31, 2001 | 60                      | 8,847 <sup>(1)</sup>     |                      |                          |

|   | December 31, |             |            |
|---|--------------|-------------|------------|
|   | 2002         | 2001        | 2000       |
| Reported net loss to common shareholders  | \$ (1,024)   | \$ (13,227) | \$ (4,142) |
| Add: goodwill amortization                | —            | 8,847       | 215        |
| Adjusted net loss                         | (1,024)      | (4,380)     | (3,927)    |
| Reported basic and diluted loss per share | \$ (0.13)    | \$ (3.11)   | \$ (0.98)  |
| Add: goodwill amortization per share      | —            | 2.08        | 0.05       |
| Adjusted basic and diluted loss per share | \$ (0.13)    | \$ (1.03)   | \$ (0.93)  |

<sup>(1)</sup> In December 2001, the Company wrote down goodwill by \$8.3 million.

As of December 31, 2002, the Company's core deposit intangible was fully amortized thus; there is no amortization expense after December 31, 2002.

### (20) Restructuring Costs

In 2001, the Company announced plans to restructure and merge all of its banking subsidiaries into one central lead bank under the holding company. This decision was made in order to reduce the costs associated with operating multiple banking subsidiaries. In connection with the restructuring, the Company recorded \$884,000 of restructuring costs. Included in the total were severance and other employee related costs including contract buyouts, write-downs of leasehold improvements associated with the subleasing of redundant property, liabilities recorded related to the subleased property, and merger costs related to data processing conversions with outside vendors. The following table rolls forward the amounts from the prior year.

|  | Liability at December 31, 2001 | Expenses Paid or Written Off in 2002 | Liability at December 31, 2002 |
|--|--------------------------------|--------------------------------------|--------------------------------|
| (Dollars in thousands)                             |                                |                                      |                                |
| Employee termination benefits and contract buyouts | \$ 395                         | \$ 395                               | \$ —                           |
| Leasehold write-downs                              | 251                            | 251                                  | —                              |
| Merger expenses                                    | 165                            | 165                                  | —                              |
| Sublease liability                                 | 73                             | 11                                   | 62                             |
|  | \$ 884                         | \$ 822                               | \$ 62                          |

### (21) Other Operating Expenses

The following shows the composition of operating expenses for the years ended December 31, 2002, 2001 and 2000:

| (Dollars in thousands)    | 2002     | 2001     | 2000     |
|---------------------------|----------|----------|----------|
| Data processing           | \$ 759   | \$ 957   | \$ 561   |
| Stationery and supplies   | 317      | 306      | 345      |
| Brokerage clearing        | 206      | 370      | 345      |
| Advertising and marketing | 541      | 368      | 241      |
| Telecommunications        | 276      | 325      | 254      |
| Other taxes               | 342      | 269      | 221      |
| Travel and entertainment  | 127      | 164      | 139      |
| Bank operations           | 411      | 875      | 165      |
| Premises and equipment    | 271      | 247      | 142      |
| Miscellaneous             | 239      | 465      | 577      |
| Total operating expense   | \$ 3,489 | \$ 4,346 | \$ 2,990 |

## Boards of Directors

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**Bernard H. Clineburg**  
*Chairman of the Board, President & CEO*

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*Vice-Chairman of the Board  
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*Retired, Founder, Chairman & CEO  
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*Chairman of the Board, President & CEO,  
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*Former Member, Fairfax County Board  
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#### Common and Preferred Stock

Cardinal's common stock symbol is CFNL, and its preferred stock symbol is CFNLP. Both are traded on The Nasdaq SmallCap Market™. As of January 31, 2003, we have 1,741 holders of our common stock and 931 holders of our Series A Cumulative Convertible preferred stock.

#### Quarterly Common Stock Prices

| Quarter Ended | Market Price |          |
|---------------|--------------|----------|
|               | High (\$)    | Low (\$) |
| <b>2002</b>   |              |          |
| March 31      | 4.00         | 3.90     |
| June 30       | 4.85         | 4.70     |
| September 30  | 4.16         | 4.11     |
| December 31   | 4.40         | 4.34     |
| <b>2001</b>   |              |          |
| March 31      | 4.88         | 3.50     |
| June 30       | 5.96         | 4.25     |
| September 30  | 6.69         | 5.18     |
| December 31   | 6.60         | 5.90     |

#### Financial Information

To obtain financial information on Cardinal Financial Corporation, contact Carl E. Dodson, Executive Vice President and Chief Financial Officer at 703-584-3400 or visit our website [www.cardinalbank.com](http://www.cardinalbank.com). The Annual Report, Form 10-K, and other corporate publications are available on request by writing to our Corporate Headquarters at 8270 Greensboro Drive, Suite 500, McLean, VA 22102.

Investment Advisory  
Cardinal Wealth Services, Inc.™  
10641 Lee Highway  
Fairfax, VA 22030

#### Annual Meeting

The 2003 Annual Meeting of Shareholders will be held on Tuesday, April 22, 2003 at 10:00 a.m. at the Hyatt Fair Lakes, 12777 Fair Lakes Circle, Fairfax, Virginia.



[cardinalbank.com](http://cardinalbank.com)

ALEXANDRIA   ARLINGTON   FAIRFAX   MANASSAS   MCLEAN   RESTON   STERLING   TYSONS CORNER